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No.

Supreme Court, U. S.
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IN THE

Supreme Court of the United States

October Term, 1978

LIBERTY LIFE INSURANCE COMPANY,
PETITIONER

v.

UNITED STATES OF AMERICA,
RESPONDENT

Petition For A Writ of Certiorari To The United States Court of Appeals For The Fourth Circuit

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IN THE SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1978

No.

LIBERTY LIFE INSURANCE COMPANY,
Petitioner
v.
UNITED STATES OF AMERICA,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Liberty Life Insurance Company petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fourth Circuit in this case.

OPINIONS BELOW

The opinion of the United States District Court for the District of South Carolina (Greenville Division) is unofficially reported at 38 AFTR 2d 76-5875 (App. A, *infra*, pp. 1a-13a). The judgment of the District Court is not reported. (App. B, *infra*, p. 14a). The order of the District Court setting forth the amount of the refund is unofficially reported at 40 AFTR 2d 77-5575 (App. C, *infra*, p. 15a). The opinion of the Court of Appeals for the Fourth Circuit is unofficially reported at 43 AFTR 2d 79-778 (App. D, *infra*, pp. 16a-30a). The opinion and order of the Court of Appeals denying petitioner's motion to dismiss respondent's appeal for lack of timeliness and challenging the jurisdiction of the Court of Appeals is unpublished. (App. E, *infra*, pp. 31a-35a).

JURISDICTION

The judgments of the Court of Appeals for the Fourth Circuit (App. F, *infra*, pp. 36a-37a) were entered on March 8,

1979. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

The questions presented by this petition are as follows:

1. Whether petitioner is entitled to allocate to investment expenses under Section 804(c)(1) of the Internal Revenue Code of 1954 a portion of the license fee which is imposed by South Carolina law on domestic life insurance companies.

2. Whether discounts granted by petitioner for advance payment of monthly premiums on mortgage cancellation policies were discounts in the nature of interest within the meaning of Section 805(e)(3) of the Internal Revenue Code of 1954.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 801, 804, 805 and 818 of the Internal Revenue Code of 1954 as amended (26 U.S.C.), and of Treasury Department Regulations Section 1.804-4 (26 C.F.R.) are set forth in App. G, *infra*, pp. 38a-47a. Also, the pertinent provisions of Sections 12-7-330(2), 12-19-150, 38-5-310 and 38-5-410 of *The Code of Laws of South Carolina* (1976) are set forth in App. H, *infra*, pp. 48a-49a.

STATEMENTS

Petitioner, Liberty Life Insurance Company, is a corporation organized and existing under the laws of the State of South Carolina with its principal place of business in Greenville, South Carolina. During 1965 petitioner qualified as a life insurance company under Section 801(a) of the Internal Revenue Code of 1954.

1. Statement On License Fee Question

South Carolina law imposes on domestic life insurance companies a license fee in an amount equal to 2% of total premiums from within the State of South Carolina, not to exceed 5% of the company's net income as computed under South Carolina tax law applicable to regular corporations. Section 38-5-410, *Code of Laws of South Carolina* (1976).

South Carolina law exempts life insurance companies from the regular corporation income tax. Section 12-7-330(2), *Code of Laws of South Carolina* (1976). Life insurance companies also do not pay any capital stock tax in South Carolina. Section 12-19-150, *Code of Laws of South Carolina* (1976). The only other assessment paid by domestic life insurance companies in South Carolina is an annual fixed fee not to exceed $300 which is collected by the Chief Insurance Commissioner and paid over to the State Treasurer. Section 38-5-310, *Code of Laws of South Carolina* (1976)[1].

In 1965, 2% of petitioner's premium income from within South Carolina was $475,946.42. Five percent of petitioner's net income was $222,911.93. Therefore, petitioner paid 5% of its net income as the license fee. (App. D, *infra*, p. 18a). This net income, as found by both Courts below, included items of investment income. (App. A, *infra*, p. 6a, and App. D, *infra*, p. 18a). Five percent of this investment income so included amounted to $173,344.75. It is this $173,344.75 which petitioner characterizes as a tax on investment income and seeks to allocate as an investment expense.

In all years since 1955 when this Statute was passed, petitioner has paid the license fee based on its net income.

Petitioner reported the license fee as an insurance expense on line 2 of Exhibit 6 of its 1965 Annual Statement.

In a decision for the government the District Court held that the license fee was based solely on premium receipts and was, therefore, allocable only to underwriting expenses. The District Court also rejected petitioner's alternative argument that the license fee was levied for the privilege of doing business in South Carolina, including the making of investments.

On appeal, the Fourth Circuit Court of Appeals affirmed

[1]At the time of the trial of this case, the 1962 version of the Code of Laws of South Carolina was in effect. For the Court's convenience, the following cross references may be helpful: Section 38-5-410 was Section 37-130.1 of the 1962 Code; Section 12-7-330(2) was Section 65-226(2) of the 1962 Code; Section 12-19-150 was Section 65-613 of the 1962 Code; and Section 38-5-310 was Section 37-121 of the 1962 Code.

the decision of the District Court, holding that the South Carolina license fee statute on its face taxed only premium income, and that there was no intention on the part of the South Carolina Legislature to impose a tax on investment income or for the privilege of doing business within the State.

II. Statement On Discount Question

In 1922 petitioner developed a plan of mortgage cancellation life insurance designed to provide funds to pay off a mortgagor's outstanding home mortgage in the event of the mortgagor's death. Petitioner's plan of mortgage cancellation insurance is a type of decreasing term life insurance and is marketed mainly through savings and loan associations (hereinafter referred to as association or associations). Premiums are billed to the association which in turn collects from the policyholder. The policyholder pays the association monthly as part of the regular monthly loan payment. The association acts as agent and receives a commission for its sales and collection services. (App. D, *infra*. pp. 24a-25a).

At the time petitioner originated its mortgage cancellation business other kinds of ordinary life insurance were generally designed for premiums to be paid annually. However, because the mortgage cancellation business was designed to coordinate with the needs of the policyholder, it provided for premiums to be paid monthly (along with the mortgage payment) and for the death benefit to decrease monthly along with the outstanding mortgage balance. It was a concept totally conceived on the idea of monthly premiums.

Until 1946 all associations remitted to petitioner monthly for each policy. (App. D, *infra*, p. 25a). In 1946, at the request of the associations, petitioner began to allow the associations the choice of paying twelve monthly premiums in advance at a discount. The amount of the discount granted by petitioner was 3%, which is approximately equivalent to 6% per annum interest rate. This percentage was determined by reference to the prevailing rate of interest of 6% per annum being charged on loans made by associations at the time. All associations, including those paying twelve months in advance, continued to collect monthly from their policyholders.

A central characteristic of the mortgage cancellation business was the right of the policyholder to terminate the insurance at the time the related mortgage loan was paid off in which case any premiums paid beyond the month of cancellation were returned to the association. In 1965 petitioner did not allow mid-year cancellation of annual premium ordinary policies. Because of the monthly nature of the business, it was necessary for petitioner to adopt certain new procedures when it began accepting twelve monthly premiums in advance. For example, in case of death, the association was refunded the advance premiums paid beyond the next monthly due date. This was not the practice with respect to annual premium business in 1946. However, as a modification of this basic concept, many insurers, including petitioner, in the late 1950's or early 1960's, began providing in their annual business policies an *additional death benefit* equal to the pro rata portion of the premium paid attributable to the period after death of the insured. This additional death benefit is really term insurance in the year of death for which an additional reserve must be set up on petitioner's Annual Statement. In contrast, for its mortgage cancellation business petitioner records the return of the unused portion at death of the advance premiums as a reduction in premium income on its Annual Statement and maintains no reserve therefor, other than the liability for advance premiums on page 3, line 9 of its Annual Statement. Where a refund was made on account of either death or other termination of insurance, the association was charged back with the commission applicable to the amount refunded. Moreover, these advance premiums did not belong to petitioner, but were a liability of the Company. It was at this time also (1946) that petitioner set up its advance premium billing and record keeping procedure. All of these practices were begun in 1946, long before the enactment of the Life Insurance Company Income Tax Act of 1959. These practices were consistent with the presence of advance premiums and reflected the obligations which petitioner has always acknowledged to its policyholders.

As the practice of paying once a year at a discount became

more prevalent, future policy form revisions incorporated provisions to reflect that practice. For example, policies introduced in 1949, 1954 and 1958 spoke in terms of payment of monthly premiums in advance at a discount and monthly due dates and also provided for the refund of monthly premiums paid in advance in the event of death.

In 1956 petitioner introduced a new level premium policy, subsequently revised in 1957, which provided for payment of premiums using a monthly or annual "mode." Also, these policies no longer included a provision for computation of the discounted annual payment because these policies used rate cards which specified the amount of both the monthly and annual payments. Both of these policies continued to base the declining death benefit on a 6% monthly amortization schedule which was carried in the policy. This was the same 6% monthly amortization schedule which was used in the previous policies. It is petitioner's position that the "mode" selected in each policy was in actuality the frequency of remittance to petitioner selected by each association. When the association chose to be billed annually petitioner still furnished the association with the monthly premium to be paid by the policyholder. The policyholder continued to pay the monthly premium to the association on all policies in force in 1965. The average discount rate granted by petitioner for 1965 was 4½%.

The changes in policy forms made no changes in petitioner's record keeping or billing system. The use of different policy forms did not change in any respect the manner in which petitioner or the associations handled the mortgage cancellation business, nor did it change the obligations of petitioner to the policyholder. It is petitioner's position that the changes in the policies did not change the basic monthly nature of the business.

Petitioner's internal practices, including accounting practices, have consistently reflected yearly payments as advance payment of twelve monthly premiums. This treatment predated the passage of the Life Insurance Company Income Tax Act of 1959. Petitioner accounted for these payments as advance premium liability on line 9, page 3 of its Annual Statement. Also, these advance premiums were included as such on

lines 4 and 14 of the Annual Statement Exhibit 1, which exhibit analyzes premium income. In contrast, when petitioner received a yearly payment on annual premium business no amount was accounted for as advance premiums.

Basically, there are two types of reserve methods used in the life insurance industry: the mean reserve and the mid-terminal reserve. The mean reserve method is the method traditionally accepted and used in the life insurance industry for calculating reserves for annual premium policies. The mid-terminal reserve method is the method traditionally accepted and used in the life insurance industry for calculating reserves for monthly premium policies. (App. A, *infra*, p. 7a). Petitioner has always used the mid-terminal reserve method for its mortgage cancellation business.

The formula for a mean reserve (MR) is written as follows:

$$MR = \frac{V_1 + V_2}{2} + \frac{P}{2}$$

The $\frac{P}{2}$ in the formula reflects the assumption in the mean reserve computation that on the average a half year's net premium is paid for coverage extending beyond the end of the accounting year.

The formula for a mid-terminal reserve (MTR) is written as follows:

$$MTR = \frac{V_1 + V_2}{2}$$

Under the mid-terminal reserve method no provision is made for a half year's net premium because it is assumed that no premium is paid for coverage extending beyond the accounting year.

The amount of $93,511.20 was included by petitioner under the heading "Discounts on prepaid premiums" on Schedule 16 of its 1965 income tax return. No part of this $93,511.20 discount was disallowed by the Internal Revenue Service on audit. This question arose by way of setoff by respondent in its answer in the District Court against any tax refund which might be obtained by petitioner.

INTRODUCTION TO TAXATION OF LIFE INSURANCE COMPANIES

The Life Insurance Company Income Tax Act of 1959 has been commonly referred to as a three-phase system. It recognizes the difficulties in actually assessing on an annual basis income and expenses of life insurance companies dealing in long term life insurance contracts. Phase one provides for the investment yield tax base and concerns only the investment income of the company which is to be taxed. Phase two provides for the taxation of one-half of the balance of the income. Phase three provides for the accumulation of both this 50% untaxed portion of the balance and certain special deductions and for determining when this accumulation will be taxed in the future.

Both issues in this petition are concerned with phase one, taxable investment income. The first step in phase one is to determine net investment yield: gross investment income from all sources, whether taxable or exempt, less investment expenses. Section 804(c). The issue as to the South Carolina license fee is whether a portion is properly treated as an investment expense. After determining net investment yield a determination is made of the total part of this net investment yield necessary to be set aside to satisfy policyholder requirements and the excess which is subject to tax as phase one income. Section 805(e). One component of policyholder requirements is the amount of interest paid. Section 805(a). Interest paid includes discount on advance premiums. Section 805(e)(3).

REASONS FOR GRANTING THE WRIT

1. Reasons On License Fee Question

The license fee question involves allocation of an expense using the "income" method of allocation; that is, whether an expense should be allocated to the operation whose income directly gave rise to the expense. There has been no question in this case but that the earning of incremental investment income caused a direct increment of 5% in the amount of petitioner's license fee. There is a potential conflict in Circuits if the Fifth Circuit Court of Appeals affirms the profit-sharing allocation

issue in *Liberty National Life Insurance Company v. United States*, 39 AFTR 2d 77-540 (D.C. Ala.). In that case the District Court decided that Liberty National's profit-sharing contribution, which was a percent of Liberty National's total net income, should be allocated against investment income to the extent that Liberty National's total net income included investment income. The respondent in that case contended that the contribution should be allocated against the operations employing the personnel to whose account the contribution was allocated. It was decided by the Courts below in the instant case that petitioner's license fee retained its characteristic as an underwriting expense even though the amount paid was directly related to the investment income earned. This is directly contrary to the holding of the District Court in *Liberty National* where compensation accruing to underwriting employees lost its characteristic as an underwriting expense and was allocated according to the income used as the measure of the contribution.

The decision on the license fee presents an important question of federal tax law which should be decided by the Supreme Court of the United States. Not only could the decision have an industry-wide effect on the allocation of state income taxes and state premium taxes between investment expenses and underwriting expenses, but it also concerns a basic theory of allocation affecting virtually every life insurance company.

As mentioned above, in all years since 1955, when the South Carolina license fee Statute was passed, until the present time, petitioner has paid its license fee based upon 5% of net income. Therefore, this is petitioner's normal tax base. It can be seen from the structure of the Statute that this would likely be true of any domestic company with a substantial portion of its insurance business in South Carolina since it would take a very high profit as a percentage of premiums for the tax on the net income to be higher than the tax on premiums. (For example, a life insurance company operating wholly in South Carolina would have to have net income in excess of 40% of its premiums in order for the 5% tax on income to exceed the 2% tax on premiums.) Therefore, the result of the Statute is that

life insurance companies such as petitioner are normally taxed on 5% of net income. Only where a domestic life insurance company conducts a fairly small portion of its insurance business in South Carolina would the premium base likely result in a smaller tax. In such a situation the premium base would actually operate as a relief provision since otherwise practically the entire net investment income would be subject to the 5% tax. For companies in petitioner's situation, the tax, therefore, has basically the same effect as a state income tax on total income. To disallow an allocation of such a tax against investment income would result in failure to consider an actual levy against the investment income. The investment income actually accruing to petitioner is net of the tax imposed thereon.

Section 804(c)(1) of the Internal Revenue Code provides for the deduction of investment expenses from gross investment income in determining investment yield. Income Tax Regulations Section 1.804-4(b)(1)(i) states that investment expenses are "those expenses of the taxable year which are fairly chargeable against gross investment income."

Section 804(c)(1) also provides a limit on the amount of the deduction if any general expenses are in part assigned to or included in investment expenses. Reg. Section 1.804-4(b)(1)(ii) provides that if an expense is attributable to more than one department, including the investment department, such expense may properly be allocated among these departments. The South Carolina license fee falls within the category of a general expense.

It is difficult to conceive of an investment expense that is more "fairly chargeable against gross investment income" than one which results directly and solely from the earning of investment income. There is no dispute that net income under Section 38-5-410 of the Code of Laws of South Carolina includes investment income, and both the District Court and Court of Appeals so held. Had taxable investment income not been included in net income, the license fee would have been $49,567.18, or $173,344.75 less than the $222,911.93 amount paid. Therefore, the $173,344.75 increase is occasioned solely by reason of the inclusion of investment income in net income. It follows, then, that since a portion of the incidence of the

license fee is upon investment income and is related to the investment side of petitioner's business, such portion is deductible as an investment expense. It was clearly an error of law for the Court of Appeals to hold that the Statute taxed only premium income and that there was no intent to impose a tax on investment income.

"Fairly chargeable" implies no preference for allocation to either investment or underwriting operations. Petitioner has shown that the license fee arises directly from earning investment income. Respondent not only has refused to accept the license fee as a direct investment expense but also has refused to permit allocation as general corporate overhead between investment and underwriting operations. There are no provisions in the Internal Revenue Code or the Regulations which prevent an allocation of license fees or state income taxes or premium taxes to investment expenses where, as in petitioner's case, there is a basis for allocation such as an increase attributable directly to investment income.

Two leading authorities on the taxation of life insurance companies say that state taxes measured by investment income are properly deductible as investment expenses. See Mertens, *Law of Federal Income Taxation*, Vol. 8, Section 44.38, p. 163; and Denney and Rua, *Federal Income Taxation of Insurance Companies*, (The Ronald Press, New York, 1961), p. 5.11.

In Rev. Rul. 76-209, 1976-1 C.B. 182, the Internal Revenue Service held that amounts paid to the States of Florida and Illinois by a life insurance company as state income taxes and state premium taxes are not allowable as deductions in computing taxable investment income under Section 804. In both States taxes paid under the income tax acts reduce the amount of premium taxes otherwise payable. Respondent recognized the relevance of whether or not the investment earnings contributed to an overall increase in tax when it stated in this ruling, "Thus, the enactment of income tax in both Florida and Illinois did not change the taxpayer's total tax liability to these two States for the taxable years here involved." This is distinguishable from petitioner's situation where the earning of investment income increased the total tax burden. Under the facts in the ruling, an increase in investment income did not

contribute towards additional tax, but merely caused a shift between premium and income taxes. Significantly, respondent conceded in its brief in the Court of Appeals that a state income tax is unquestionably imposed on investment as well as underwriting earnings.

Respondent argued extensively the question of why the license fee should be labeled a "premium tax" and then asserted that, once so labeled, the law is clear that a premium tax is not deductible as an investment expense. South Carolina law does not call the tax a premium tax, petitioner does not record it on its Annual Statement as a premium tax, and the tax does not function in petitioner's case as a premium tax. The tax is what it is: neither pure premium tax nor pure income tax, but rather South Carolina's own peculiar license fee. The propriety of allocating this tax should depend on the characteristics of the tax and not on whether it may or may not more properly be labeled a "premium tax."

In summary, the Court of Appeals based its decision on labeling the license fee as a premium tax and not on a thoughtful analysis of its structure and effect on petitioner. Petitioner has always paid the license fee based upon its net income and the effect on petitioner has always been exactly the same as a simple income tax. There is no dispute that net income includes investment income, and the District Court and the Court of Appeals so held. Therefore, a portion of the license fee should be allowed as an investment expense.

Petitioner's alternative argument is that the license fee is a tax for doing all business in South Carolina, including its investment business, and is, therefore, an allocable general expense. All of the expert witnesses in this case, including respondent's expert witness, agreed that the license fee is a fee for doing business in South Carolina, including making investments.

In *New World Life Insurance Company v. United States*, 26 F. Supp. 444 (Ct. Cl. 1939), aff'd *per curiam*, 311 U.S. 620, 61 S. Ct. 314 (1940), in footnote 11, the Court said:

> Among other expenses of a general nature which could with equal facility be apportioned and assigned in part to the investment department, the following might be mentioned — (10) license fees paid to various states for the privilege of doing business therein.

For the reasons stated above, the petition for a writ of certiorari on the license fee question should be granted.

II. Reasons On Discount Question

The discount issue involves a question similar to that decided in the case of *Liberty National Life Insurance Company v. United States*, 39 AFTR 2d 77-540 (D.C. Ala.). If the decision in that case is affirmed by the Fifth Circuit a potential exists for a conflict between the Fourth and Fifth circuits. In addition, the decision on the discount issue presents an important question of federal tax law which should be decided by the Supreme Court of the United States.

Provision for allowing the inclusion of discount on prepaid premiums as interest paid was first made by the Life Insurance Company Income Tax Act of 1959. Under prior law it had been held that such discount was not "interest paid on indebtedness" and, consequently, not deductible from investment income. *Illinois Life Insurance Company v. Commissioner*, 30 B.T.A. 1160 (1934), rev'd on other grounds, 299 U.S. 88, 57 S. Ct. 63, 81 L. Ed. 56 (1936), and *Monarch Life Insurance Company v. Commissioner*, 38 B.T.A. 716 (1938), aff'd 114 F. 2d 314 (1 Cir. 1940). Discounts in the nature of interest, whether or not guaranteed, on premiums paid in advance on insurance contracts are now specifically includible under Section 805(e) (3).

An eminent insurance authority, Thomas G. Nash, in Volume 1 of his work, *Federal Taxation of Life Insurance Companies*, Section 19.04, page 194, states that the addition of Paragraph (3) to Section 805(e) in the Life Insurance Company Income Tax Act of 1959 expands the intent of Congress to allow as interest paid all amounts reasonably attributable to the Company's contract or other policy liabilities. He goes on to say that this evidences a meticulous effort on the part of Congress to allow all amounts of interest credited to life insurance or annuity contracts, *regardless of the technical limitations of the word "interest."* (Emphasis supplied.)

Section 805(e) of the Internal Revenue Code provides four

categories of interest items the sum of which constitutes the "interest paid" by a life insurance company for any taxable year. It is, in fact, difficult to conceive of a situation in which insurance companies actually do allow interest or amounts in the nature of interest and not get a benefit in the investment income computations of phase one. The manner in which the benefit of interest is given in phase one varies depending on the particular arrangement at hand, but phase one consistently allows a credit for *all* interest allowed by a life insurance company.

It is obviously basic to the life insurance business that a company does not pay out money in advance of the time it has contracted to do so without charging interest and does not expect policyholders to let the company use the policyholders' funds without the benefit of interest. As will be demonstrated below, there was clearly an interest element in the differential between the total of twelve monthly premiums and the lesser amount accepted as advance payment of these monthly premiums.

Premiums on conventional annual premium life insurance are due at the beginning of the year of coverage and, are, therefore, paid "in advance." However, this is not the type of advance premium to which Section 805(e) (3) refers. Although the policyholder is allowed the benefit of interest on this payment, an insurance company gets the phase one benefit of this interest by including the premium attributable to coverage past year-end in the *mean reserve*. The fact that the policyholder has, on the average, paid for a half year's coverage beyond year-end is reflected by the inclusion of "½ P" in the formula: $MR = \frac{V_1 + V_2}{2} + \frac{P}{2}$. When this mean reserve is multiplied by the reserve rate, Section 805(a) (1), the insurance company gets the phase one benefit for the interest on this portion (½ P) of the premium paid for coverage beyond year-end.

Where a payment is made for twelve months in advance on petitioner's mortgage cancellation policies, petitioner has allowed the payor the benefit of interest from having paid this amount a year in advance rather than monthly during the year. It is proper for petitioner to allow the payor a discount because petitioner, having received the money, has it available for

investment. However, because of the use of the *mid-terminal reserve*, petitioner does not get the benefit of this interest under Section 805(a)(1). Had petitioner considered this to be an annual premium policy, the "½ P" would have been included in the mean reserve and that would have been the manner in which petitioner would have been allowed the benefit of interest. However, this is not the case with petitioner's mortgage cancellation business since the mid-terminal reserve assumes the payment of no premium beyond year-end. Where the mid-terminal reserve is used petitioner has no less given the policyholder the benefit of interest and petitioner should get the benefit of this interest in phase one as discount on advance premiums.

Petitioner submits that the following is a crucial distinction between prepayment of monthly premiums on its mortgage cancellation business and an annual premium on annual business: payments on its mortgage cancellation business are advance premiums because they are received *in advance of the time assumed in the mid-terminal reserve computation*, whereas an annual premium on annual business is received *at the time assumed in the mean reserve computation*. If the discount is not allowed in phase one, there would be a situation where petitioner is, in fact, allowing discount for the payment of an amount of money at an earlier time but where no phase one benefit is allowed. In addition, the receipt of these premiums in advance gives rise to investable funds creating investment income taxed in phase one. The cost of obtaining these funds should be allowed as a phase one policyholder requirement, either as required interest on reserves (which the mid-terminal reserve method does not accomplish), or as discount on premiums paid in advance. Otherwise, there would be an increment of investment income with no offset for the directly related cost. This is clearly contrary to the Congressional intent to allow the benefit in phase one of all interest allowed by an insurance company. An interpretation of Section 805(e)(3) avoiding this inconsistent result should have the presumption of correctness.

One of the most significant factors evidencing the nature of the mortgage cancellation business is the fact that petitioner

has consistently treated the prepayment of monthly premiums as advance premiums in all matters of substance. Petitioner's treatment should be given special consideration because it is the industry originator of this line of business, and the treatment was established before the passage of the current tax law. Among the more important practices adopted by petitioner's personnel through the years were the accounting for the premiums as advance premiums, the accounting for premiums refunded at death of the insured, and the use of the mid-terminal reserve method.

Advance premiums must be accounted for as a liability and not included in premium income because they represent policyholder funds. The accounting for these premiums as advance premiums rather than as premium income caused petitioner's earnings to be smaller. Petitioner's accounting for the refund of advance mortgage cancellation policy premiums on death of the insured did not include the additional reserve necessitated by the counterpart in annual premium policies. Petitioner also recorded refunds of advance mortgage cancellation premiums as reductions in premium income. This is the type of accounting treatment which the Supreme Court of the United States said is entitled to great weight in *Standard Life and Accident Insurance Company v. Commissioner*, 433 U.S. 148, 97 S. Ct. 2523, 53 L. Ed. 2d 653 (1977). See also Section 818(a) of the Internal Revenue Code of 1954.

Petitioner's use of the mid-terminal reserve method for its mortgage cancellation business is further indication of its determination that such business is monthly business since the mid-terminal reserve method is the reserve method clearly identifiable with monthly business. Petitioner's accounting and reserving practices with respect to its mortgage cancellation business have been accepted by the insurance examiners and independent auditors.

If it is concluded that prepayment of monthly premiums on petitioner's mortgage cancellation business gave rise to advance premiums, there can be no question that the discount allowed thereon was in the nature of interest. The District Court and the Court of Appeals found that interest was present in the discount. (App. A, *infra*, p. 8a and App. D, *infra*, p. 27a).

Respondent also conceded that the discount included interest. The District Court and the Court of Appeals plainly erred in disallowing the entire amount of discount. Except for the policy fee included in the rate schedules used with the 1956 and 1957 policies, petitioner's conversion between monthly and annual premiums was accomplished by use of a flat percent factor which is indicative of an interest discount computation.

Advance premiums were first allowed in 1946 at the request of the associations. For prepayment petitioner allowed a 3% front-end discount, which is approximately equivalent to a 6% annual interest rate. Petitioner's witness testified that the discount was determined by reference to the prevailing rate of interest of 6% per annum being charged on loans made by the associations at that time. The 6% interest rate was arrived at as the amount necessary to make the prepayment, plus interest on the prepayment being charged the policyholder by the association, equal the sum of the monthly payments being made by the policyholder to the association.

The conclusions of the District Court and the Court of Appeals that the discount was the result of expense savings and, therefore, not in the nature of interest is unsupported by the evidence. There was no clear showing that there was *any* net expense savings other than the commission on the discount. The testimony amply showed that any net expense savings to petitioner were minimal. A conclusion that expense savings was the reason for granting the discount has no basis in fact.

The Court of Appeals pointed to Congressional Committee reports dealing with the 1959 Act explaining that Section 805 applies to interest similar to that allowed on bank deposits. This wording obviously represented an attempted simplification to distinguish from other more technical "interest" benefits allowed by the new law on reserves, etc. It should be noted that these committee reports applied to Section 805(e) in general and were not made specifically in reference to discounts on advance premiums. No kind of advance premium arrangement, including an advance premium deposit agreement, creates interest similar to that on a bank deposit.

For the reasons stated above, the petition for a writ of certiorari on the discount question should be granted.

CONCLUSION

It is respectfully submitted that this Court hold in abeyance its decision on this petition pending the outcome of *Liberty National Life Insurance Company v. United States*, 39 AFTR 2d 77-540 (D.C. Ala.). That case is currently on appeal to the Fifth Circuit where oral argument was heard on April 25, 1979. If the decision in the *Liberty National* case creates a conflict between the Fourth and Fifth Circuits on the license fee or discount issues, then this Court should resolve that conflict. If the decision in the *Liberty National* case does not create a conflict on the license fee or discount issues, then this Court is urged to grant this petition for a writ of certiorari in order to resolve these important questions of federal tax law.

Respectfully submitted,

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Greenville, South Carolina 29601

Counsel for Petitioner

JUNE, 1979

APPENDICES

APPENDIX A

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF SOUTH CAROLINA
GREENVILLE DIVISION

LIBERTY LIFE INSURANCE COMPANY *Plaintiff* *vs.* UNITED STATES OF AMERICA *Defendant*	CIVIL ACTION 73-1538 FINDINGS OF FACT CONCLUSIONS OF LAW AND ORDER

This action was instituted by the plaintiff Liberty Life Insurance Company pursuant to 28 USC §1346(a), seeking to recover income taxes in the amount of $87,660.71 for the year 1965, including interest, alleged to have been erroneously collected from it by the defendant.

The dispute arises from the adoption by Liberty Life of a novel accounting method whereby certain items are considered to be investment expenses within the meaning of 26 USC §804(c)(1). The United States asserts by way of set-off, a claim for taxes not paid for the year 1965, alleging that certain items were erroneously included as interest paid within the meaning of 26 USC §805(e).

The parties entered into a stipulation of facts and exhibits and trial was had on the remaining portions of the case on July 22, 1975. It is upon the testimony at trial and the stipulated facts and exhibits that the Court makes its findings of fact and conclusions of law pursuant to Rule 52 of the Federal Rules of Civil Procedure.

FINDINGS OF FACT

1. The Court incorporates by reference the stipulation of facts and exhibits submitted by the parties and admitted into evidence with the exception of paragraph 19, as agreed by the parties.

2. Plaintiff Liberty Life Insurance Company, a corporation organized under the laws of the State of South Carolina, with its principal place of business in Greenville, South Carolina, filed a timely United States Life Insurance Company Income Tax Return (Form 1120L) for the calendar year 1965 and paid the taxes shown to be due thereon in the amount of $1,232,224.61.

3. The Internal Revenue Service audited plaintiff's 1965 tax return and assessed additional taxes of $103,417.34, plus interest of $18,166.03 on February 20, 1969. Plaintiff paid the additional taxes plus interest.

4. On March 11, 1971, plaintiff filed a timely claim for refund of taxes paid for the year 1965 in the amount of $87,660.71, plus interest. In November of 1973 plaintiff filed a timely supplemental claim for refund for 1965, making changes in calculations, but requesting refund in the same amount as in the original claim.

5. In November, 1971, the Internal Revenue Service notified plaintiff that it had disallowed the original claim for refund.

6. On November 21, 1973, Liberty Life filed a timely complaint in this Court seeking a refund of taxes paid for the year 1965. Plaintiff challenged only the following issues: inclusions of prepaid expenses in assets, disallowance of a portion of plaintiff's 801(b) reserve on the grounds that it is an unearned premium reserve, the disallowance as investment expenses of a portion of the South Carolina graded license fee, advertising expenses and commissions.

7. Defendant filed a general denial and, in addition, alleged as set-off against any refund which might be obtained by plaintiff an additional adjustment due to the inclusion of certain items as discounts in the nature of interest. Plaintiff replied with a denial.

8. Plaintiff and defendant have reached agreement on the following issues raised by plaintiff's claim: advertising expenses (Stip., par. 12), prepaid expenses (Stip., par. 21), unearned premium reserve (Stip., par. 24).

9. The only issues remaining for decision by this Court are: plaintiff's claim as investment expenses of a portion of the

South Carolina graded license fee and of commissions and defendant's claim of set-off for interest paid.

10. There is no dispute as to venue or jurisdiction.

Commissions:

11. On its 1965 income tax return, Liberty Life claimed a deduction of $238,356.00 as an investment expense. The sum claimed represented a portion of the commissions paid to branch managers, staff managers and combination agents (hereinafter field representatives) which was claimed to have been paid as compensation for work done in making and servicing policy loans.

12. Under the insurance tax code, policy loans are considered to be investments.

13. Liberty Life is atypical of other insurance companies in that its field representatives perform duties in connection with policy loans ordinarily handled by home office personnel. These duties include explaining the terms of the loans, filling out applications, processing the loan application, personally delivering the loan checks, collecting the loan payments, etc.

14. These duties consume a substantial amount of the time of the combination agents, staff managers and branch managers. Staff managers and branch managers have duties in connection with each loan application and must also perform the duties of any combination agent who is unavailable. A time study conducted in 1974 confirmed that a substantial amount of the time of field representatives (5%) was spent in performing their duties in connection with making and servicing policy loans. Testimony established that substantial amounts of time is spent in performing such duties.

15. Evidence established that more time was spent by the field representatives in servicing policy loans already in force than was spent in making new loans.

16. Field representatives are given no separate compensation for their services in connection with policy loans.

17. Contracts with the field agents provide, and the Court finds, that compensation (commissions) was provided for all services rendered the company. Commissions included

compensation for making and servicing policy loans. Defendant concedes as much. (Defendant's proposed findings, par. 11).

18. Field representatives were paid by commissions. Agents' commissions are based on a percentage of premiums collected for policies in force and a separate percentage for acquiring a new policy. The percentage is determined by a number of factors including the type of policy, size of the policy and premium payment, the frequency of payments (whether weekly or monthly), longevity, and so forth. None of the factors included in determining the size of the commissions is directly related to the services rendered in connection with making and servicing policy loans. No separate compensation is received for these services although the employment contract states that the compensation is also for services, which would include services connected with policy loans. Staff managers and branch managers are also compensated by commissions based on the performance of their personnel. They also are paid for their services and are not separately compensated for work done in connection with policy loans.

19. Field representatives are also required to make policy loans for policies which are fully paid. Field representatives are not given commissions on policies which are fully paid.

20. In order to arrive at a figure for the amount paid to field representatives for services in connection with policy loans, Liberty Life multiplied the number of new policy loans on weekly premium, monthly debit and ordinary life policies serviced by combination agents by $2.00 and multiplied the number of loans in force on weekly premium, monthly debit and ordinary life policies services by combination agents during the tax year by $4.00. The total arrived at was $238,356.00 which was deducted as an investment expense on plaintiff's tax return.

21. It is unclear precisely how the $2.00 and $4.00 figures were arrived at. However, the Court concludes on the basis of the testimony that they were reasonable amounts for the agents' time spent in performing their duties. As calculated, $2.00 represented the value of all of the field agents' time spent during one year on a new policy. The duties included

filling out, approving, processing and delivering applications for loans. The $4.00 figure represented the value of all of the field agents' time spent during one year in collecting payments and performing other duties associated with a loan already in force. The evidence established that substantially more time is consumed performing these duties than is spent in obtaining and processing new policy loans.

22. The method of allocating a portion of commissions to the category of investment expenses is inconsistent with the methods used by the National Association of Insurance Commissioners on their Annual Statement.

23. Liberty Life did not allocate any portion of its commissions to the category of general expenses or investment expenses in its Annual Statement for 1965.

License Fee:

24. Under South Carolina law a domestic life insurance company is required to pay a license fee:

> *Two percent graded license fee on domestic life insurance companies.* — In addition to any and all other license fees or taxes there is hereby imposed upon each domestic life insurance company of any class licensed by the Commissioner and incorporated under the laws of this State, an additional and graded license fee in an amount equal to two percent of the total premiums, that is, total premium income or total premium receipts, from insurance contracts issued to residents of this State or paid from a point located within this State, less any dividends or bonuses paid in cash or applied in abatement of premiums or credited to policyholders of such company, as collected from citizens of or residents of this State during the year next preceding the date of the return. Such premiums shall not include considerations received from annuity contracts. The additional and graded license fee imposed in this section shall not exceed five percent of the net income of the company as determined under the provisions of chapter 5 of Title 65; provided, that in addition to the deductions allowed by such chapter there shall be allowed in computing net income any addition to policy

reserves as may be required by the Commissioner, but no more than such required amount. §37-130.1, *Code of Laws of S.C.* 1962.

25. In 1965, 2% of premiums gathered within the State of South Carolina by Liberty Life would have amounted to $475,946.42. Accordingly, Liberty Life paid 5% of its net income, or $222,911.93, following examination by the South Carolina Tax Commission.

26. Net income includes investment income. Liberty Life calculated 5% of its gross investment income amounted to $173,344.75 and claimed that sum as an investment expense in its supplemental claim for refund to the Internal Revenue Service. Plaintiff contends that the inclusion of investment income by the South Carolina license fee constitutes a tax on investment and is, therefore, deductible.

27. South Carolina imposes on foreign life insurance companies a license fee based on 2% of premiums collected with the State. §37-122, *Code of Laws of South Carolina* (1962). A reduction of the license fee is available for instate reinvestment in specified securities and property of over 25% of the reserves of South Carolina policies. §37-123, *Code of Laws of South Carolina*.

28. Domestic insurance companies are exempt from normal state corporation income tax and capital stock tax.

Discounts In The Nature Of Interest:

29. Liberty Life offers mortgage cancellation insurance, now in the form of decreasing term, level premium policies. Mortgage cancellation insurance is obtained by a borrower from a savings and loan association and is designed to pay his indebtedness in the event of his death prior to repayment of the obligation.

30. The savings and loan association is the beneficiary of the policy and also sells the insurance and receives a commission for sales made.

31. The savings and loan also collects the monthly premiums. Originally, the premiums were paid monthly to Liberty Life by the savings and loan.

32. However, beginning in 1946, Liberty Life agreed to

accept an annual payment from the savings and loan association in an amount less than the total of the monthly payments. The savings and loan associations continued to collect full monthly payments from the policyholders (borrowers).

33. It is the difference between the total monthly payments and the lesser annual payment, *mutatis mutandis*, which is the source of the dispute here.

34. In 1956, Liberty Life began offering a choice between annual and monthly "modes" of payment on its policy forms. In that same year plaintiff began calculating its monthly premiums by taking a percentage of its annual rate (.08833 × annual rate). Use of the formula resulted in total monthly payments greater than the annual rate.

35. The technique of taking a percentage of an annual rate to arrive at a monthly rate is typical of conversion from one "mode" of payment to another.

36. As of 1965, the year in question, Liberty Life offered only decreasing term, level premium mortgage cancellation insurance. For policies over $5,000 in that year, plaintiff charged a $10.00 "policy fee" for annual premiums. Monthly premiums were calculated as follow: .085 × annual rate + $.90. Thus, a larger sum was paid both for the basic charge for coverage and for the "policy fee" when paid monthly than when paid annually.

37. In its 1965 tax return plaintiff claimed the difference between total annual and total monthly payments (including the "policy fee") as discounts in the nature of interest on prepaid premiums.

38. Should a policyholder cancel the insurance, Liberty Life refunds the remaining amount of the payment beyond the end of the month of cancellation. This refund does not include interest.

39. Annual premium life insurance policies refund unearned premiums at death. This refund is termed a "death benefit."

40. Liberty Life calculates its reserves on mortgage cancellation insurance by use of the mid-terminal reserve system, traditionally used in the industry for monthly payment policies. However, its reserves could as easily be calculated by use of

the mean reserve method although such a transfer would involve a great deal of expense. Annually paid premiums may also be calculated by use of the mid-terminal reserve method. No distinction which would advance this inquiry appears to exist between the two systems.

41. Liberty Life did not calculate its annual premium by calculating the present value of future payments. If such a calculation had in fact been used, the interest factor would have been substantially higher than that used to calculate its "Advance Premium Deposit Agreements." This agreement permits a policyholder to pay future payments by paying their present value using a specific rate of interest. The policyholder is then credited with the full payment each year when the premium falls due. The difference between the present and future value of the premiums is then considered to be a discount in the nature of interest on prepaid premiums.

42. The discount for annual payment consisted in large part of savings on expenses. By receiving payment annually Liberty Life was not required to make separate entries for monthly payments, separate billings, etc. A substantial amount of savings was also had in commissions which were not paid to the savings and loan associations.

43. Plaintiff did not report the "deductions" as interest paid to the Internal Revenue Service (Form 1099) as would be required by law if the deductions did represent interest.

44. The Court finds that the annual payment for mortgage life insurance was a "mode" of payment. The lesser amount paid was the result of expense savings; and to some extent, the value of the use of money from the beginning of the year. Certain competitive advantages would also result from the offering of such a discount.

CONCLUSIONS OF LAW

1. This Court has jurisdiction of this case. 28 USC §1346(a). Venue is uncontested.

Commissions:

2. Liberty Life has adopted a novel method of accounting whereby certain amounts of the compensation paid to their

field representatives would be allocated to investment expenses.

3. The Income Tax Regulations §1.804-4(b) (1) (i) defines investment expenses, *Delphically*, as "those expenses of the taxable year which are fairly chargeable against gross investment income." "General expenses," that is, expenses incurred for the benefit of more than one department, may be allocated among the departments which they benefit. §1.804-4(b) (1) (ii).

4. Policy loans are investments, due to the fact that they earn interest, and are treated as such by the Internal Revenue Service. Nash, *Federal Taxation of Life Insurance Companies*, Vol. 1 §31.19(3) p. 31-52 (1974).

5. Thus, expenses incurred in the making and servicing of policy loans may be considered to be investment expenses. Salaries of personnel working in the investment department handling policy loans may be deducted as an investment expense. Salaries of those who contribute a part of their time for the benefit of the investment department may be apportioned to investment expenses.

6. No relevant distinction exists between apportioning a straight salary and compensation paid on a commission basis. That portion of money paid to an agent which represents compensation for services rendered to the investment department may be considered to be an investment expense.

7. The Court has found that $2.00 is a reasonable amount to be considered to be compensation to be paid for the substantial services rendered by field representatives during the first year of a policy loan. The Court has also found that $4.00 represents a fair amount to be considered compensation paid for the greater services rendered by field representatives during the year that a policy loan is in force.

8. While the method of allocation is acceptable, it is not the best method of arriving at a proper allocation.

9. Plaintiff was entitled to allocate $2 per new policy and $4 per policy in force to the category of investment expenses.

10. The United States argues that the method of accounting employed by the plaintiff is inconsistent with the methods ap-

proved by the National Association of Insurance Commissioners for its Annual Statement. The Internal Revenue Code, 26 USC §818(a), provides:

> "(a) Method of accounting. — All computations entering into the determination of the taxes imposed by this part shall be made —
>
> (1) under an accrual method of accounting, or
>
> (2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).
>
> Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners."

11. The Court does not read the Code as requiring that otherwise allowable tax deductions under the Code are barred by the instructions of the NAIC. See *Jefferson Standard Life Insurance Company v. United States*, 408 F. 2d 842 (4th Cir. 1969). Nor is the reverse true, that deductions allowed by the NAIC should be considered proper under the Code. The NAIC instructions must be considered "guidelines" and in no way conclusive of the issues in this case.

License Fee:

12. Liberty Life's position is that as "net income," 5% of which is the upper limit of the state license fee, includes investment income, the license fee is in part an investment tax, or investment expense, and therefore deductible.

13. If the South Carolina license fee were based on premium receipts alone and did not include "net income" in the calculation at all plaintiffs would not have a case. The entire amount would be charged as a part of "insurance expenses."

14. The South Carolina license fee is based on premium receipts alone. Investment income becomes a factor only in the event that 2% of the premium receipts exceeds 5% of net income, including investment income. Investment income is merely a factor in determining a limit to liability and does not form the basis of the liability.

15. Plaintiff's position is the result of a logical fallacy. It is not enough to argue that "but for" the inclusion of investment income in the calculation of net income plaintiffs would have paid $173,344.75 less. The argument does not establish that the amount paid was caused by the inclusion of investment income. In fact, the contrary is true. "But for" the limitation to 5% of net income (including investment income) the plaintiff's license fee would have been sustantially greater. The inclusion of net income in the formula reduced the amounts due to the State of South Carolina.

16. As the state license fees were not the result of investment income they were not investment expenses and Liberty Life is not entitled to allocate a portion of the fee to investment expenses.

17. Plaintiff further argues that since the license fee is only imposed on domestic insurance companies, which would normally have extensive instate investments, the fee is imposed for the privilege of doing business in South Carolina, including investment activity. The fee should, therefore, be considered to be in part an investment expense.

18. Liberty Life ignores South Carolina Code §37-122 which imposes an identical 2% graded license fee on foreign life insurance companies. South Carolina Code §37-123 offers a reduction of the license fee for reinvestment of over 25% of the reserves of South Carolina policies which are reinvested instate in specified securities and property. Thus, an incentive is offered for local investment by foreign life insurance companies. Foreign and domestic companies' fees are assessed on the same base. Domestic companies' fees are cut off at 5% of net income but no corresponding limitation is granted to foreign companies.

19. The South Carolina fee is based *solely* on premium income from within the state. It is in no way connected with the amount of investment activity within the state or elsewhere. If Liberty Life collected no premiums in the state but did make extensive investments, it would pay no license fees at all. Since no expense is incurred as the result of conducting investment

business within the state, no portion of the license fee may be treated as an investment expense.

Discounts For Prepayment:

20. In its answer to plaintiff's claims for overpayment on the preceding issues, the United States raised as an offset tax allegedly due on certain deductions subsequently disallowed by the Internal Revenue Service. The three-year statute of limitations would otherwise have barred the United States from assessing the deficiency but it is permitted to raise the issue as an offset to any refund to which the plaintiff may be entitled. *Lewis v. Reynolds*, 284 U.S. 281 (1932). Should the United States prove that a reasonable basis exists for the offset, the burden shifts to the plaintiff to establish that it was entitled to treat the items as discounts in the nature of interest. *Missouri Pacific Railroad Co. v. United States*, 338 F. 2d 668 (Ct. Cl. 1964). *Missouri Pacific Railroad Co. v. United States*, 411 F. 2d 327 (8th Cir. 1969).

22. The Court finds that defendant met its burden of proof that there is a reasonable basis for its position that plaintiff was not entitled to treat its annual premiums on mortgage cancellation insurance as discounted prepaid premiums and the difference between the annual and aggregate monthly payments as being in the nature of interest.

23. 26 U.S.C. §805(e)(3) defines as "interest paid" within the meaning of "policy and other contract liability requirements" referred to in 26 U.S.C. §804(a):

> "*Discount on prepaid premiums.* — All amounts accrued for the taxable year for discounts in the nature of interest . . . on premiums or other consideration paid in advance on insurance or annuity contracts."

24. This portion of the Code was passed in response to two decisions, *Commissioner v. Monarch Life Insurance Company*, 114 F. 2d 314 (1st Cir. 1940) and *Illinois Life Insurance Company v. Commissioner*, 30 B.T.A. 1160 (1934, affirmed 80 F. 2d 289 (7th Cir. 1935), reversed on other grounds, 299 U.S. 88 (1936). While the facts of the latter case are unclear, in the former, the company apparently permitted the policyholder to deposit funds with the company in advance

of the due date. The company calculated the present value of the future premiums at a certain interest rate and permitted the policyholder to deposit the reduced amount. At the time each policy fell due, the policyholder's account was credited with the full amount of the premium. The court refused to consider the discount to constitute interest paid.

25. The system undertaken by Liberty Life in effect is annual coverage and not a prepayment of monthly premiums, regardless of the method used by the savings and loan association to collect their payments from the borrowers. The coverage effected by this plan was, in effect, annual. The repayment of unearned premiums in the event of cancellation during the term and the use of the mid-terminal reserve method of accounting do not mitigate against such a conclusion.

26. Further, the discount given was not in the nature of interest. The discount went, in this case, to the beneficiary-agent (the savings and loan) rather than to the policyholder. The arrangement was of mutual benefit in that both parties saved a substantial amount in bookwork and other costs by entering into such an arrangement. An additional advantage was offered to the insurance company in its competitive position against other companies seeking the same markets.

27. Since the amounts in question were neither prepaid premiums nor discounts in the nature of interest, the Court concludes that the Government must prevail on its offset.

Conclusion:

The Court, therefore, finds that plaintiff's deduction of a portion of its commissions as investment expenses on its 1965 income tax return was permissible under the Code, that its deduction of a portion of the South Carolina graded license fee as an investment expense was impermissible. The Court finds that defendant must prevail on its counterclaim as plaintiff's treatment of the difference between its annual premiums and the total of the monthly premiums for mortgage cancellation insurance as discounts in the nature of interest was inconsistent with the Code.

Judgment shall be entered accordingly.

ROBERT F. CHAPMAN
United States District Judge

August 20th, 1976
Columbia, South Carolina

APPENDIX B

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF SOUTH CAROLINA
GREENVILLE DIVISION

LIBERTY LIFE INSURANCE COMPANY *vs.* UNITED STATES OF AMERICA	CIVIL ACTION FILE NO. 73-1538 JUDGMENT

This action came on for (hearing) before the Court, Honorable Robert F. Chapman, United States District Judge, presiding, and the issues having been duly (heard) and a decision having been duly rendered,

It is Ordered and Adjudged that Plaintiff's deduction of a portion of its commissions as investment expenses on its 1965 income tax return was permissible under the Code, that its deduction of a portion of the South Carolina graded license fee as an investment expense was impermissible. The Court further finds that the Defendant must prevail on its Counterclaim as Plaintiff's treatment of the difference between its annual premiums and the total of the monthly premiums for mortgage cancellation insurance as discounts in the nautre of interest was inconsistent with the Code.

Dated at Columbia, South Carolina, this 24th day of August, 1976.

MILLER C. FOSTER, JR.
Clerk of Court

BY: ELAINE MCGEE
Deputy Clerk

APPENDIX C

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF SOUTH CAROLINA
GREENVILLE DIVISION

LIBERTY LIFE INSURANCE COMPANY *Plaintiff,* *vs.* UNITED STATES OF AMERICA *Defendant.*	ORDER CIVIL ACTION NO. 73-1538

Whereas, on August 20, 1976, the Court made its Findings of Fact, Conclusions of Law and Order in the above entitled case and directed that Judgment be entered accordingly; and

Whereas, on August 24, 1976, pursuant thereto, a Judgment was filed on a separate document entitled "Judgment on Decision By the Court" containing the substance of said Findings, Conclusions and Order and the same was entered on the docket by the Clerk of Court on that date, and

Whereas, it was the intention of the Court that the Judgment so entered on August 24, 1976 be its final Judgment in the case since it disposed of all issues in dispute, and all that remained to determine the amount of the refund was a mathematical computation which could be performed by the parties without the aid of the Court, and

Whereas, it having been made known to the Court that the parties have agreed upon the computation of the refund to which plaintiff is entitled pursuant to said Judgment.

It is hereby ordered that the amount of refund due to the plaintiff pursuant to said Judgment be $31,587.57 together with interest as provided by law and that plaintiff have and recover said sum from defendant pursuant to the said Judgment previously entered in this case.

ROBERT F. CHAPMAN
U.S. District Judge

June 14, 1977

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 77-2161

LIBERTY LIFE INSURANCE COMPANY,
Plaintiff-Appellee-Cross-Appellant

v.

UNITED STATES OF AMERICA
Defendant-Appellant-Cross-Appellee.

No. 77-2162

LIBERTY LIFE INSURANCE COMPANY,
Plaintiff-Appellant-Cross-Appellee

v.

UNITED STATES OF AMERICA,
Defendant-Appellee-Cross-Appellant

Appeals from the United States District Court
for the District of South Carolina
(Greenville Divison)
ROBERT F. CHAPMAN, *Judge*

Argued October 4, 1978 Decided March 8, 1979

Before WINTER, *Circuit Judge*, COWEN*, *Senior Judge*, and PHILLIPS, *Circuit Judge*.

David A. Merline for Appellant in 77-2162 and for Appellee in 77-2161; Gary R. Allen, M. Carr Ferguson, Assistant Attorney General, Gilbert E. Andrews and James E. Crowe, Jr., (Thomas E. Lydon on brief) for Appellee in 77-2162 and for Appellant in 77-2161.

*Wilson Cowen, Senior Judge of the Court of Claims, sitting by designation.

COWEN, *Senior Judge:*

Liberty Life Insurance Company (hereinafter referred to also as plaintiff and taxpayer) is a South Carolina corporation which issues various kinds of insurance. Liberty Life filed a timely United States Life Insurance Company Income Tax Return (form 1120L) for the calendar year 1965 and paid the taxes shown thereon. On March 11, 1971, plaintiff filed a timely claim for refund of some of its 1965 taxes; the Internal Revenue Service disallowed the claim in November of 1971. Following a suit in the district court for a refund of the taxes paid, both parties have appealed to this court from the judgment of that court.

Three issues are presented for our determination: (1) whether a portion of a South Carolina graded license fee may be described as an investment expense[1] within the meaning of that term as used in 26 U.S.C. §804(c)(1); (2) whether a portion of the commissions plaintiff paid to its field representatives may be described as an investment expense under the same section; and (3) whether a discount plaintiff grants to savings and loan associations for yearly payment of a mortgage cancellation insurance premium is a "discount in the nature of interest" within the meaning of 26 U.S.C. §805(e)(3).[2]

The district court decided[3] the second of these issues in favor of plaintiff and on June 14, 1977, entered judgment ordering a refund of $31,587.67 in taxes, plus interest. The Government filed a timely appeal. The other two issues were decided in favor of the Government and the taxpayer duly filed its cross-appeal. We agree with the trial judge's well-drawn findings of fact and with his cogent and enlightening conclusions of law. Therefore, we affirm the judgment of the court below in its entirety.

[1] Under the complicated federal scheme for taxing life insurance companies, investment expenses receive a tax treatment more favorable to the taxpayer than that accorded to other kinds of expenses.

[2] This last issue arises under a Government counterclaim by way of offset, since the 3-year statute of limitations would bar the Government from raising the issue directly. *Lewis v. Reynolds*, 284 U.S. 281 (1932).

[3] *Liberty Life Ins. Co. v. United States*, 40 AFTR 2d 77-5575, (D. S.C. 1977).

I. The License Fee

The state of South Carolina imposes on all domestic life insurance companies doing business within the state a license fee in an amount determined by the total premium income of the company. Specifically, §37-130.1 of the Code of Laws of South Carolina (1962) in effect at the time provided that all domestic life insurance companies must pay a graded license fee of 2 percent of their total premium income or total premium receipts from insurance contracts issued to South Carolina residents, or paid from points within the state. The fee is subject to a maximum limitation of 5 percent of the net income of the company from all sources. In 1965, 2 percent of the South Carolina premiums received by Liberty Life amounted to $475,946.42, while 5 percent of its net income was only $222,911.93. Therefore, Liberty Life paid 5 percent of its net income as the graded license fee.

Net income includes investment income. Plaintiff reasoned that when the license fee was calculated with reference to net income, it was partly a tax on investment income; accordingly, it deducted 5 percent of its gross investment income (that is, $173,344.75) as an investment expense on its 1965 tax return. The Commissioner disallowed this deduction, and his disallowance was upheld by the district court.

The taxpayer makes three arguments in its appeal of this decision. The first is based on the fact that in every year since this statute was passed, Liberty Life has paid 5 percent of its net income rather than 2 percent of its total premium receipts. In order for the premium receipts to be the smaller figure, a life insurance company's net income would have to exceed 40 percent of its gross premium income. Since this was not true for Liberty Life and (it submits) is unlikely to be true for *any* normally operated life insurance company, plaintiff argues that the intent of the statute, evidenced by its net effect in practice, must have been to impose a tax based, at least in part, on investment income.

The fallacy of this argument is that the statute on its face taxes only premium income, and there is nothing in the legislative history or elsewhere which contradicts the clear language of the law. It would have been a simple matter for the legislature to have levied a tax on net income had it desired to do so. It seems clear to us that the legislature did not so intend. Rather, the intent was to levy a tax on premium income and at the same time to fix a maximum limit for the tax so that it would not take too large a bite out of the net income of the insurance companies. This provision was doubtless intended to provide an incentive for insurance companies to do business in the state. Plaintiff's argument is rejected because we do not believe that the legislature intended to tax net income in such a roundabout way.

Second, plaintiff argues that the fee must have been in part a tax on investment income, since but for that income, the fee would have been less. Since the higher tax was occasioned by the inclusion of investment income in net income, says plaintiff, the amount of increase constituted a tax on investment income and should be deductible as an investment expense. This argument, however, is logically defective. The liability imposed by the statute is 2 percent of the gross premium income. The limitation to the 5 percent of net income under the statutory plan is simply a way of calculating how much of that liability the plaintiff actually has to pay. This much is clear from the language of the statute:

> ***The additional and graded license fee imposed in this section shall not exceed five percent of the net income of the company***. §37-130.1, *Code of Laws of S.C.*, 1962.

This language does not convert the premium fee into a tax on investment income. The fortuity that the legislature chose a formula which included investment income to determine the maximum limit of the tax does not alter the character of the fee itself.

Finally, plaintiff argues that since the fee is by far the largest sum it pays to the state each year, the charge is in reality a tax on the privilege of doing business — *all* business, including investment business — in the state. Plaintiff points to a comment in *New World Life Ins. Co. v. United States*, 88 Ct. Cl. 405, 435n. 26 F. Supp. 444, 459n (1939), *aff'd per curiam* 311 U.S. 620 (1940), which suggests that a fee paid to a state for the privilege of doing business there might be apportioned to the investment department of the company.

This may be a correct statement of the law when the fee paid is genuinely unsusceptible of allocation to any particular part of the life insurance company's business. If the statute by its terms imposed the fee for the privilege of transacting business within the state, the plaintiff's argument would have some force. But this fee expense appears to be fully allocable. It is a fee based on premium income. The legislature has not chosen to tax (by way of a fee) investment income as well. This is a policy decision with which we need not be concerned, and which does not determine for us the character of the fee which the legislature imposed. Furthermore, as the Government suggests, South Carolina's imposition of an identical fee (2 percent of gross premiums) on foreign life insurance companies, §37-122, *Code of Laws of S.C.* (1962), is strong evidence, if more were needed, that the tax on premiums is exactly what it appears to be, especially since the foreign companies' fee is not limited to 5 percent of net income.[4]

In short, plaintiff's arguments have not convinced us that the South Carolina premium-based license fee is anything other than what it plainly appears to be. Consequently, the district court's holding on this issue is affirmed.

II. The Commissions

Like most other insurance companies, Liberty Life issues loans on the security of its customers' insurance policies. Unlike many other insurance companies, the work required to service these loans (explaining the terms of the loans, filling out applications, and collecting the loan payments, for example) is done not by home office employees but by field representatives. The district court found that these representatives spent about 5 percent of their total working time performing loan services.

Liberty Life pays its field representatives by commissions, which are calculated by using a number of factors related to the insurance policies they issue. None of these factors depends in any way on the work done in servicing policy loans.

[4] The foreign companies do receive a reduction in fee for reinvesting their South Carolina policy reserves within the state.

Liberty Life assigned dollar values (in amounts found to be reasonable by the trial judge) to the loan services performed by the field representatives and, using these figures, determined the total amount of the field representatives' compensation that was attributable to the loan services.

The company then deducted this amount ($238,356) as an investment expense on its 1965 income tax return. The trial judge held that this deduction was allowable. The Government disagrees.

The Government maintains that agents' commissions are deductible solely as underwriting expenses under the statutory taxation scheme. Since investment expenses receive more favorable tax treatment than underwriting expenses, the Government argues that in order to effectuate the Congressional intent, investment expense treatment should be allowed only to those expenses which actually generate investment income. The Government points to the following facts in support of its contention that field representatives' commissions do not meet this standard: (1) The commissions are based solely on premium income, regardless of the loan services actually performed by each individual agent; (2) the policy loans made by Liberty Life are more in the nature of a service to its customers, since they are not particularly profitable to the company; (3) the calculations for the premiums to be paid take into account possible loan services to be rendered on the policy; (4) the primary function of the agent is the generation of underwriting income, and the servicing of policy loans as a convenience to the customer is merely another aspect of this primary function; and (5) the National Association of Insurance Commissioners (NAIC) specifically recommends that commissions of field representatives, including compensation for "collection or service fees," be treated as underwriting expenses, not as general expenses subject to allocation.

Keeping in mind the applicable standard,[5] we find that we do not need to dip deeply into the statutory history and the analysis of commentators to assess the significance of the facts

[5] Investment expenses are "those expenses of the taxable year which are fairly chargeable against gross investment income." Treas. Reg. §1.804-4 (b)(1)(i).

enumerated above. The issue is simple and clear-cut: Does the loan servicing work of the field representatives generate investment income? If so, an allocable portion of the commissions paid as compensation for those activities is a legitimate investment expense. The district court determined that the field representatives' duties in making and servicing the policy loans generated investment income and, finding the allocated compensation for those duties reasonable, allowed the deduction as an investment expense. We find ourselves in complete agreement with that conclusion.

There is no question that if these services had been performed by home office employees, the salaries of those employees would have been deductible as an investment expense. We fail to see any difference in effect when those duties are performed as Liberty Life has arranged — by agents in the field. The Government's arguments enumerated above fail to persuade us otherwise: (1) the use of premiums alone for calculating the agents' commissions is not dispositive, since those commissions are intended as full compensation for all of the agents' duties, including the loan work. (2) The profitability of the policy loans as investments is also of little significance in this inquiry; profitable or not, the loans were legitimate interest-bearing investments with expenses connected to them. (3) The inclusion in the premium calculation of the costs of loan services actually supports the plaintiff's position, since the compensation for the field representatives' services is calculated directly from those premiums. (4) Plaintiff's motive in making the policy loans is irrelevant to the question of whether or not they were investments. Plaintiff no doubt offered these loans to make its underwriting business more attractive to prospective clients. Nevertheless, the loans generated investment income, and we find no requirement of "investment intent" in the statute, regulations, or legislative history. (5) The NAIC standards are applicable to "computations" made in determining the federal tax on life insurance companies. 26 U.S.C. §818(a); *see Commissioner v. Standard Life & Accident Ins. Co.*, 433 U.S. 148, 158-59 (1977). They are not controlling on substantive questions of allocation. *Jefferson Standard Life Ins. Co. v. United States*, 408 F.2d 842, 849-50 (4th Cir. 1969), *cert. denied* 396 U.S. 828 (1969). The deduction as an investment expense of that portion of the field representatives' compensation which was fairly allocable to loan services was permissible under the applicable statute and regulations.

III. The Discounts In The Nature Of Interest

As provided in 26 U.S.C. §805(e)(3), the following sums will be excluded from the company's share of net investment yield for the purposes of determining the company's taxable investment income:

> All amounts accrued for the taxable year for discounts in the nature of interest, whether or not guaranteed, on premiums or other considerations paid in advance on insurance or annuity contracts.

This section was added to the Code by the Life Insurance Company Income Tax Act of 1959, Pub. L. 86-69, 73 Stat. 112. The Senate Report which accompanied the 1959 Act noted that a deduction was allowed for "interest *** on prepaid premiums to the extent of the accrual during the year" since such payments "are similar in nature to the deduction for interest paid or credited on deposits by a bank and therefore properly are not taken into account in determining the income of the life insurance company making the payment." S. Rep. No. 291, 86th Cong., 1st. Sess., pp. 16-17, 1959-2 Cum. Bull. p. 782; H. Rep. No. 34, 1959-2 Cum. Bull, p. 742.

Aside from the foregoing statement, we have found nothing in the scanty legislative history to disclose what Congress intended by the new provision. However, prior to the enactment of the 1959 Act, there were several cases which dealt with interest deductions claimed on account of discounts granted on advance payment of premiums. In *Monarch Life Ins. Co. v. Commissioner*, 38 B.T.A. 716 (1938), *aff'd* 114 F.2d 314 (1st Cir. 1940), the insurance company permitted the policyholder to deposit funds with the company in advance of the due date; calculated the present value of the future premiums at a certain discount rate, and permitted the policyholder to deposit the reduced amount. As each premium became due, the policyholder's account was credited with the full amount of the premium. The First Circuit held that the discount was not interest

paid, since it was not a payment for the use of borrowed money and was in no sense interest on indebtedness. A similar result was reached in *Illinois Life Ins. Co. v. Commissioner*, 30 B.T.A. 1160 (1934). However, in *Equitable Life Assurance Soc. v. Commissioner*, 44 B.T.A. 293 (1941), *modified and aff'd on other grounds* in 137 F.2d 623, (2d Cir. 1943), *aff'd* 321 U.S. 560 (1944), an insurance company accepted funds from certain accident and health policyholders with the agreement that the company would hold the fund on demand and supplement it with interest at a specified rate; in the event the policyholder did not demand repayment of the fund, the company would apply it, together with the interest supplement, in payment of premiums becoming due on the policy. At any time prior to the due date of the policy, the company would repay the fund to the policyholder on demand. The court allowed the interest deduction, saying that "credit for practical purposes is the equivalent of payment." Although we have found no mention of case law in the legislative history, the district court found that section 805(e)(3) was passed in response to the *Monarch* and *Illinois Life Insurance* decisions and both parties have accepted this view.

In the absence of more explicit legislative history, we may begin by ascribing the normally accepted meaning to a "deduction for interest paid or credited on deposits by a bank." Central to the idea of "interest" is compensation — a payment or credit of interest to another for the privilege of holding and using his money. Thus, the discount arrangements made in *Monarch Life* and *Equitable Life Assurance Society, supra*, would qualify for the interest deductions as discounts "in the nature of interest." In each case, the policyholder was compensated by the insurance company for the early use and enjoyment of his money. With this background, it remains now to examine the facts surrounding the discounts granted by Liberty Life to determine whether they were truly "in the nature of interest."

In 1922 Liberty Life developed a system of mortgage cancellation life insurance. This system was designed to pay off a mortgagor's outstanding home mortgage balance in the event of his death prior to the mortgage termination. The insurance is

marketed through mortgagee institutions, primarily savings and loan associations. Liberty Life bills these associations for the mortgage cancellation premiums; the associations in turn collect the premiums from the policyholders, who generally remit the premiums in monthly installments as part of their regular mortgage payments. The associations receive a commission for the sale and collection of the mortgage cancellation insurance.

Until 1946 the associations remitted the mortgage cancellation premiums monthly to Liberty Life, but in that year the company began offering the associations the option of remitting the 12 monthly premiums in advance for each year or paying a single annual lump sum at a 3 percent front-end discount. Since then, the company has expanded and diversified this option, so that for the taxable year 1965 the discounts granted ranged from 3.65 to 7.25 percent. It is these discounts which are at issue here.

In 1956, Liberty Life issued a new type of policy for its mortgage cancellation insurance business. The policy specifically provided for payment of premiums on a monthly, quarterly, semiannual, and annual basis. The contract read in part as follows:

> CONSIDERATION: This policy is issued in consideration of the application herefor and of the payments in advance as hereinafter provided of the premium specified in the schedule. The first such premium shall be payable on delivery hereof and a like premium shall be due and payable annually, semi-annually, quarterly, or monthly, according to the Mode of Premium Payments, every twelve calendar months, six calendar months, three calendar months, or one calendar month, respectively, as the case may be, from the Date of Issue until premiums shall have been paid to the end of the Premium Paying Period or until the prior death of the Insured.

This was a level premium insurance policy, and such policies constituted in excess of 80 percent of the company's mortgage cancellation business in force in 1965.

We begin our inquiry into whether the annual premiums

paid by the savings and loan associations were advance payments of 12 monthly premiums by reference to the district court's findings. The court found that the annual payment for the mortgage cancellation life insurance was a "mode" of payment. As previously stated, the taxpayer began in 1956 to issue a new type of mortgage cancellation insurance policy which provided for premium payments on an annual, semiannual, quarterly, or monthly basis. The policy specifically referred to the schedule of payments as a "mode of premium payments." As the district court found, plaintiff began calculating its monthly premiums in 1956 by taking a percentage of its annual rate, and the use of this formula resulted in total monthly payments greater than the annual rate. Significantly, the district court also found that the technique of taking the percentage of an annual rate to arrive at a monthly rate is typical of conversion of one "mode" of payment to another. On the basis of this and other evidence, the district court properly concluded that:

> The system undertaken by Liberty Life in effect is annual coverage and not a prepayment of monthly premiums, regardless of the method used by the savings and loan association to collect their payments from the borrowers. The coverage effected by this plan was, in effect, annual. *** [*Liberty Life Insurance Co. v. United States*, 40 AFTR 2d 77-5581.]

The district court's conclusion is supported by the contrast between plaintiff's treatment of its premium deposit agreements on other forms of insurance and its treatment of the premiums paid on its mortgage cancellation insurance. Liberty had premium deposit agreements with its policyholders similar to those involved in *Equitable Life Assurance Co., supra*. The agreements permitted the policyholder to pay future payments by paying their present value using a rate of interest which was usually 3.5 to 4 percent. The policyholder was then credited with the full payment each year when the premiums fell due. However, as the district court found, Liberty Life did not calculate its annual premium on the mortgage cancellation insurance by computing the present value of future payments. The real interest factor in the discounts at issue here was "substantially higher than that used to calculate its Advance Premium Deposit Agreements." We think that these facts demonstrate quite clearly that the discount claimed here bore little or no relation to the amount which Liberty expected to earn during the year 1965 on the annual premiums deposited by the associations, and therefore, the discount was not "a discount in the nature of interest."

There is no doubt that an element of interest was included in the discounts given to the associations, but that fact aids plaintiff's case very little. All insurance premiums are "paid in advance" in the sense that they are generally received by the company at the period of the beginning of the coverage. On ordinary life insurance policies, the policyholder may elect to make payments at more frequent intervals than once a year, but he is usually charged slightly more for the privilege of spreading out the payments. This surcharge does not convert the difference between the total of the frequent payments and the amount of the single annual payment into an interest discount. Surely, the Congress intended to require something more than this in order to permit the deduction authorized by section 805(e)(3). We think that this section of the Code deals with special situations and requires a showing that some further interest benefit is offered by the insurance company for genuine advance deposits.

The record reflects that there are several other substantial similarities between the payment scheme at issue here and that used in an ordinary, annual term, variable mode life insurance policy. The district court found that when a policyholder cancelled a mortgage insurance policy, the remaining amount of the payment beyond the end of the month of cancellation was refunded. However, the refund did not include interest. It was simply a pro rata portion of the amount actually paid by the associations. Refunds on ordinary, annual life insurance policies are computed on essentially the same basis.

In an effort to distinguish its refunds of the annual payment mortgage cancellation premiums from annual payment ordinary life refunds, Liberty argues that the unexpired term covered by the premiums on the mortgage cancellation business belongs to the associations until the monthly premiums become due, and therefore, that on cancellation, Liberty Life

refunds a portion of the mortgage insurance annual premium which relates to the unexpired term covered thereby. However, the record shows that Liberty Life adopted the same practice with reference to the annual payment, ordinary life policies which were cancelled. As a company witness explained, the refund practices with respect to the two types of insurance had merged.

Also, there was no substantial difference in plaintiff's handling of death-time refunds. On its ordinary life policies, Liberty Life granted the policyholder the option of acquiring the right to refund of unearned portions of the premium on early cancellation by paying a small extra premium which went into a separate reserve. Liberty Life then paid a death benefit to the policyholder if the insured died before the full term had run. This arrangement is substantially identical to the refund of "unearned prepaid monthly premiums" which Liberty Life provided for mortgage cancellation insurance. Consequently, we do not agree that these formal differences, which are minimal, affect the result which we have reached.

Liberty Life also argues that the use of the midterminal reserve method of computing liability on its mortgage cancellation business is strong evidence of the fact that the annual premiums paid by the associations were advance payment of monthly premiums. However, the district court found that the plaintiff's reserves could have been as easily calculated by the mean reserve method, although changing methods would involve a great deal of expense. The court also found that annually paid premiums may also be calculated by the midterminal reserve method. Liberty Life has not shown that this finding is clearly erroneous and although the company's accounting procedure in this respect is entitled to some weight, we do not think it is sufficient to justify the special treatment afforded by section 805(e)(3).

In resolving an issue where the legislative history offers us so little assistance, we rely heavily, as the district court did, on the fact that the discount rates offered by Liberty Life were much higher than one would expect for an allowance of interest. As already stated, the front-end discount rates ranged from 3.65 to 7.25 percent, generating an effective rate of between 7

and 14 percent. These rates are even higher when the differences provided by the plaintiff's policy fees are taken into account. The evidence does not show that Liberty Life had any pressing need for the immediate use of the money or that such a need induced it to grant an especially high interest rate. Consequently, the high rate suggests that more was at work than a discount "similar in nature to the deduction for interest paid or credited on discounts by a bank." The figure is high enough to raise a reasonable suspicion that the discount must be something else than a credit for interest. The district court found from conflicting evidence that the "something else" consisted in large part of savings on expenses associated with the less frequent payments. The plaintiff saved on commissions payable to the savings and loan associations, because the commissions were calculated from the discounted premium. The necessity of 12 separate billing cycles was eliminated. The court also found that competitive advantages accrued to Liberty Life by the offering of the lower discounted rate. Although plaintiff challenges these findings, it has not shown that they were clearly erroneous, and we adopt them for the purpose of this decision.

The Government relies on the district court's finding that Liberty Life did not report on Internal Revenue Service form 1099 the deductions here claimed as interest. There is no evidence that any of the associations reported the discounts granted by plaintiff as interest income. However, we do not rely on this finding as a controlling factor in our decision, because of the confusion that may well have been generated by a change in the rulings which the Internal Revenue Service issued on the subject. Rev. Rul. 65-199, 1965-2 Cum. Bull. 20, held that any increment in the value of advance, or prepaid premiums, or of premium deposit funds applied to the payment of premiums on life insurance policies would result in taxable income to the policyholder and should be reported on form 1099. However, this was a reversal of a prior ruling, Rev. Rul. 65-24, 1965-1 Cum. Bull. 31, which held that the discounts should not be included in the income of the premium payer or reported by the insurance company. Moreover, the 1965 ruling stated that where advance premiums had been deposited on or

before July 8, 1965, the new position would be applied only to increments credited or made available for withdrawal subsequent to the first premium due date falling after July 31, 1965.[6]

Our attention has been called to *Liberty National Life Ins. Co. v. United States*, 39 AFTR 2d 77-540 (N.D. Ala. 1976), on appeal to the Fifth Circuit. This is a case in which interest treatment was allowed. Although we do not agree entirely with the rationale of that decision, we think the case is distinguishable on its facts. There, a small company, the predecessor to Liberty National, issued small burial policies with weekly premiums of less than one dollar. An acute shortage of funds caused it to offer a discount on advance premiums paid 52 weeks in advance, and also a smaller discount on advance premiums paid 26 weeks in advance. After the company was merged with Liberty National in 1944, the discount practice was continued. The court found that the expense factor was unaffected by the discount; that there were no expense savings, and that there was an increase in costs incurred in handling the additional accounting. Also, the court explicitly found that the discount constituted interest income to the premium payers.

By contrast, the discounts claimed in this case consisted largely of savings on expenses and were granted by a financially sound insurance company because of the resulting competitive advantages. The district court found that Liberty Life's discounts were given for reasons unrelated to a desire for immediate possession and use of the premium money. The court below correctly concluded that the reductions in the annual premiums paid by the associations were not prepaid premiums nor discounts "in the nature of interest" as contemplated by Congress.

The judgment of the district court is

AFFIRMED.

[6] *See also* Rev. Rul. 66-120, 1966-1 Cum. Bull. 14, which adopted a transitional rule to protect taxpayers who might have relied on previous rulings.

APPENDIX E

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 77-2161

LIBERTY LIFE INSURANCE COMPANY
Appellee

versus

UNITED STATES OF AMERICA
Appellant

No. 77-2162

LIBERTY LIFE INSURANCE COMPANY
Appellant

versus

UNITED STATES OF AMERICA
Appellee

Appeal from the United States District Court
for the District of South Carolina
at Greenville
ROBERT F. CHAPMAN, *District Judge*

Submitted October 19, 1977 Decided December 27, 1977

Before BOREMAN, *Senior Circuit Judge*, and WINTER and BUTZNER, *Circuit Judges*

David A. Merline, counsel for the Appellee in No. 77-2161 and cross-appellant in No. 77-2162, Liberty Life Insurance Company; Myron C. Baum, M. Carr Ferguson, Tax Division, Department of Justice, and James D. McCoy III, Assistant United States Attorney, counsel for the Appellant in No. 77-2161 and cross-appellee in No. 77-2162, United States of America.

Per Curiam Opinion and

ORDER

This case involves a threshold question concerning the timeliness of an appeal by the government from a judgment of a district court. The question presented is which of two series of judicial and ministerial acts — one on August 24, 1976 and the other on June 14, 1977 — constituted the "judgment" and "entry of judgment." If it was the former, this appeal is out of time; but if the latter, this appeal is timely.

The facts are clear and undisputed. Liberty Life Insurance Co. (Liberty) brought suit in the United States District Court for the District of South Carolina seeking a refund of income taxes paid for the taxable year 1965. Prior to trial the parties entered into a stipulation of facts and exhibits which was submitted to the court and contained the following:

> The amount of refund, if any, to which plaintiff is entitled as a result of this action, shall be computed by plaintiff, subject to the review and approval of defendant. In the event of a dispute between the parties as to the amount of refund, the matter shall be submitted to the Court for its decision.

After a trial on the merits the district court directed entry of judgment on August 20, 1976 pursuant to its findings of fact and conclusions of law. The court's order of August 20, 1976 provided in pertinent part:

> The Court, therefore, finds that plaintiff's deduction of a portion of its commissions as investment expenses on its 1965 income tax return was permissible under the Code, that its deduction of a portion of the South Carolina graded license fee as an investment expense was impermissible. The Court finds that defendant must prevail on its counterclaim as plaintiff's treatment of the difference between its annual premiums and the total of the monthly premiums for mortgage cancellation insurance as discounts in the nature of interest was inconsistent with the Code.
>
> Judgment shall be entered accordingly.

Pursuant to this direction by the court, the clerk of court entered a "Judgment on Decision by the Court" on August 24,

1976 on a separate document as required by Rule 58 of the Federal Rules of Civil Procedure. The clerk used substantially the same language used by the district court quoted above.

No notice of appeal was given by either party within 60 days as required by Rule 4 of the Federal Rules of Appellate Procedure. However, Liberty did not submit to the government its computation of the amount of refund based upon the court's findings and conclusions until more than 60 days had elapsed from the order of August 20, 1976. Although the parties agreed upon the amount of refund based upon the court's order, the government refused to process payment of the refund until the court entered an order setting forth the exact dollar amount of the refund which the parties had computed from the court's earlier order. In a letter to plaintiff's attorney the government attorney took the position that "a monetary judgment must be entered both for the purpose of processing the payment of any refund due plaintiff and, also, to form the predicate for any possible appeal from the Court's ruling." (Appendix at 22)

On June 14, 1977 the district court entered an order in this case setting forth the exact dollar amount of the refund due Liberty, based upon the principles stated, adopted and applied by the court in its earlier opinion and order and the subsequent computation by the parties of the amount due. The order of June 14, 1977 states in its entirety:

> Whereas, on August 20, 1976, the Court made its Findings of Fact, Conclusions of Law and Order in the above entitled case and directed that Judgment be entered accordingly; and
>
> Whereas, on August 24, 1976, pursuant thereto, a Judgment was filed on a separate document entitled "Judgment on Decision By the Court" containing the substance of said Findings, Conclusions and Order and the same was entered on the docket by the Clerk of Court on that date, and
>
> Whereas, it was the intention of the Court that the Judgment so entered on August 24, 1976 be its final Judgment in the case since it disposed of all issues in dispute, and all that remained to determine the amount of the refund was a mathematical computation which could be

performed by the parties without the aid of the Court, and

Whereas, it having been made known to the Court that the parties have agreed upon the computation of the refund to which plaintiff is entitled pursuant to said Judgment.

It is hereby ordered that the amount of refund due to the plaintiff pursuant to said Judgment be $31,587.57 together with interest as provided by law and that plaintiff have and recover said sum from defendant pursuant to the said Judgment previously entered in this case.

The clerk of court made a docket entry setting forth the amount of the refund and the government filed a notice of appeal from this order within the time provided by Rule 4 of the Federal Rules of Appellate Procedure.

Liberty has filed a motion to dismiss the appeal on the ground that the August 1976 judgment was final and the government's notice of appeal was not timely filed. The government argues that in a suit for a refund of taxes a specific dollar amount is a prerequisite to a final decision and, therefore, the June 1977 order is the final judgment in the case and the notice of appeal was timely.

We cannot agree with the government's contention that a specific dollar amount is a prerequisite to a valid final judgment. All that is required for a final judgment for money is that it "specify the *means* for determining the amount." *United States v. Schaefer Brewing Co.*, 356 U.S. 227, 233 (1958) (emphasis added); *accord, Ram. v. Paramount Film Distributing Corp.*, 278 F.2d 191, 193 (4 Cir. 1960) (a dollar amount *or the means* of determining a dollar amount must be set forth in a judgment). As recognized by the district court in the instant case, all that needed to be done after the August 1976 judgment, to arrive at the exact amount of the refund, was a "mathematical computation which could be performed by the parties without the aid of the Court." *See Hattersley v. Bollt*, 512 F.2d 209, 213-14 (3 Cir. 1975). An indication that the court provided sufficient "means" to determine the amount of the refund was that there was no dispute between Liberty and the government as to the amount of the refund based upon their interpretation of the court's findings. While the clerk's entry of judgment on

August 24, 1976 would doubtless convey little to a stranger to the litigation, to those familiar with the case and attentive to the question of appeal it conclusively conveyed the vital information necessary to protect their interests.

Nevertheless, the August 1976 order and entry of judgment was *not* the final judgment in this case for purposes of appeal. The parties' stipulation which was submitted to the court and accepted by it prior to trial provided that the *parties* would compute the amount of refund from the court's findings, but in the event of a dispute between the parties as to the exact dollar amount the *court* would resolve the dispute. Thus the court, by accepting the stipulation and allowing the parties to compute the amount of refund, in effect agreed to continue its jurisdiction over the case until such time as the parties agreed upon the amount of refund based upon the court's findings. The stipulation removed the question of computation from the trial, but the court was empowered to intercede and adjudicate the amount of the refund, after the trial, if a dispute arose between the parties over the computation of the refund based upon the court's findings. Because of this continuing jurisdiction of the court until such time as the parties agreed upon a sum certain, the order of June 14, 1977, recognizing the agreement of the parties as to the amount of the refund and the entry of the agreed upon amount into the record, more clearly represents the final judgment in this case than does the August 1976 order. *See Superior Life Insurance Co. v. United States*, 462 F.2d 945, 947-48 (4 Cir. 1972). Therefore, the government's notice of appeal was timely filed and Liberty's motion to dismiss the appeal should be denied.

IT IS SO ORDERED.

APPENDIX F

JUDGMENT

UNITED STATES COURT OF APPEALS
FOR THE
FOURTH CIRCUIT

No. 77-2161

LIBERTY LIFE INSURANCE COMPANY
Appellee

v.

UNITED STATES OF AMERICA
Appellant

APPEAL FROM the United States District Court for the District of South Carolina.

THIS CAUSE came on to be heard on the record from the United States District Court for the District of South Carolina, and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court appealed from, in this cause, be, and the same is hereby, affirmed.

A True Copy, Teste:
William K. Slate II, Clerk
By M. Sue Olshfski
Deputy Clerk

WILLIAM K. SLATE II
Clerk

JUDGMENT

UNITED STATES COURT OF APPEALS
FOR THE
FOURTH CIRCUIT

No. 77-2162

LIBERTY LIFE INSURANCE COMPANY
Appellant

v.

UNITED STATES OF AMERICA
Appellee

APPEAL FROM the United States District Court for the District of South Carolina.

THIS CAUSE came on to be heard on the record from the United States District Court for the District of South Carolina, and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court appealed from, in this cause, be, and the same is hereby, affirmed.

A True Copy, Teste:
William K. Slate II, Clerk
By M. Sue Olshfski
Deputy Clerk

WILLIAM K. SLATE II
Clerk

APPENDIX G

CODE SEC. 801. DEFINITION OF LIFE INSURANCE COMPANY.

(a) Life Insurance Company Defined. – For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if —

(1) its life insurance reserves (as defined in subsection (b)), plus

(2) unearned premiums and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves, comprise more than 50 percent of its total reserves (as defined in subsection (c)).

* * *

SEC. 804. TAXABLE INVESTMENT INCOME.

(a) In General. –

(1) Exclusion of policyholders' share of investment yield. – The policyholders' share of each and every item of investment yield (including tax-exempt interest and dividends received) of any life insurance company shall not be included in taxable investment income. For purposes of the preceding sentence, the policyholders' share of any item shall be that percentage obtained by dividing the policy and other contract liability requirements by the investment yield; except that if the policy and other contract liability requirements exceed the investment yield, then the policyholders' share of any item shall be 100 percent.

(2) Taxable investment income defined. – For purposes of this part, the taxable investment income for any taxable year shall be an amount (not less than zero) equal to the amount (if any) of the net capital gain plus the sum of the life insurance company's share of each and every item of investment yield (including tax-exempt interest and dividends received), reduced by —

(A) the sum of —

(i) the life insurance company's share of interest which under section 103 is excluded from gross income, and

(ii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by paragraph (4)) computed with respect to the life insurance company's share of the dividends received; and

(B) the small business deduction provided by paragraph (3)

For purposes of the preceding sentence, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of paragraph (1), equals 100 percent.

(3) Small business deduction. – For purposes of this part, the small business deduction is an amount equal to 10 percent of the investment yield for the taxable year. The deduction under this paragraph shall not exceed $25,000.

(4) Application of section 246(b). – In applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of this subsection, the limit on the aggregate amount of the deductions allowed by sections 243(a)(1), 244(a) and 245 shall be 85 percent of the taxable investment income computed without regard to the deductions allowed by such sections.

(b) Gross Investment Income. – For purposes of this part, the term "gross investment income" means the sum of the following:

(1) Interest, etc. – The gross amount of income from —

(A) interest, dividends, rents, and royalties,

(B) the entering into of any lease, mortgage, or other instrument or agreement from which the life insurance company derives interest, rents, or royalties, and

(C) the alteration or termination of any instrument or agreement described in subparagraph (B).

(2) Short-term capital gain. – The amount (if any) by which the net short-term capital gain exceeds the net long-term capital loss.

(3) Trade or business income. – The gross income from any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner. In computing gross income under this paragraph, there shall be excluded any item described in paragraph (1).

Except as provided in paragraph (2), in computing gross investment income under this subsection, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

(c) Investment Yield Defined. – For purposes of this part, the term "investment yield" means the gross investment income less the following deductions —

(1) Investment expenses. – Investment expenses for the taxable year. If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed the sum of —

(A) one-fourth of one percent of the mean of the assets (as defined in section 805(b)(4)) held at the beginning and end of the taxable year,

(B) the amount of the mortgage service fees for the taxable year, plus

(C) whichever of the following is the greater:

(i) one-fourth of the amount by which the investment yield (computed without any deduction for investment expenses allowed by this paragraph) exceeds 3¾ percent of the mean of the assets (as defined in section 805(b)(4)) held at the beginning and end of the taxable year reduced by the amount described in subparagraph (B), or

(ii) one-fourth of one percent of the mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees for the taxable year.

(2) Real estate expenses. – The amount of taxes (as provided in section 164), and other expenses, for the taxable year exclusively on or with respect to the real estate owned by the company. No deduction shall be allowed under this paragraph for any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property.

(3) Depreciation. – The deduction allowed by section 167. The deduction under this paragraph and paragraph (2) on account of any real estate owned and occupied for insurance purposes in whole or in part by a life insurance company shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this sentence) as the rental value of the space not so occupied bears to the rental value of the entire property.

(4) Depletion. – The deduction allowed by section 511 (relating to depletion).

(5) Trade or business deductions. – The deductions allowed by this subtitle (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner; except that in computing the deduction under this paragraph —

(A) There shall be excluded losses —

(i) from (or considered as from) sales or exchanges of capital assets

(ii) from sales or exchanges of property used in the trade or business (as defined in section 1231(b)), and

(iii) from the compulsory or involuntary conversion (as a result of destruction, in whole or in part, theft or seizure, or an exercise of the power of requisition or comdemnation or the threat or imminence thereof) of property used in the trade or business (as so defined).

(B) Any item, to the extent attributable to the carrying on of the insurance buisness, shall not be taken into account.

(C) The deduction for net operating losses provided

in section 172, and the special deductions for corporations provided in part VIII of subchapter B, shall not be allowed.

SEC. 805. POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS.

(a) In General. – For purposes of this part, the term "policy and other contract liability requirements" means, for any taxable year, the sum of —

(1) the adjusted life insurance reserves, multiplied by the adjusted reserves rate,

(2) the mean of the pension plan reserves at the beginning and end of the taxable year, multiplied by the current earnings rate, and

(3) the interest paid.

(b) Adjusted Reserves Rate and Earnings Rates. –

(1) Adjusted reserves rate. – For purposes of this part, the adjusted reserves rate for any taxable year is the average earnings rate or, if lower, the current earnings rate.

(2) Current earnings rate. – For purposes of this part, the current earnings rate for any taxable year is the amount determined by dividing —

(A) the taxpayer's investment yield for such taxable year, by

(B) the mean of the taxpayer's assets at the beginning and end of the taxable year.

(3) Average earnings rate. –

(A) In general. — For purposes of this part, the average earnings rate for any taxable year is the average of the current earnings rates for such taxable year and for each of the 4 taxable years immediately preceding such taxable year (excluding any of such 4 taxable years for which the taxpayer was not an insurance company).

(B) Special Rules. — For purposes of subparagraph (A), the current earnings rate for any taxable year of any company which, for such year, is an insurance company (but not a life insurance company) shall be determined as if this part applied to such company for such year.

(4) Assets. – For purposes of this part, the term "assets" means all assets of the company (including nonadmitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business. For purposes of this paragraph, the amount attributable to —

(A) real property and stock shall be the fair market value thereof, and

(B) any other asset shall be the adjusted basis of such asset for purposes of determining gain on sale or other disposition.

(c) Adjusted Life Insurance Reserves. –

(1) Adjusted life insurance reserves defined. — For purposes of this part, the term "adjusted life insurance reserves" means —

(A) the mean of the life insurance reserves (as defined in section 801(b)), other than pension plan reserves, at the beginning and end of the taxable year, multiplied by

(B) that percentage which equals 100 percent —

(i) increased by that percentage which is 10 times the average rate of interest assumed by the taxpayer in calculating such reserves, and

(ii) reduced by that percentage which is 10 times the adjusted reserves rates.

(2) Average interest rate assumed. – For purposes of this part, the average rate of interest assumed in calculating reserves shall be computed —

(A) by multiplying each assumed rate of interest by the means of the amounts of such reserves computed at that rate at the beginning and end of the taxable year, and

(B) by dividing (i) the sum of the products ascertained under subparagraph (A), by (ii) the mean of the total of such reserves at the beginning and end of the taxable year.

(d) Pension Plan Reserves. – For purposes of this part, the term "pension plan reserves" means that portion of the life insurance reserves which is allocable to contracts —

(1) purchased under contracts entered into with trusts which (as of the time the contracts were entered into) were deemed to be (A) trusts described in section 401(a) and exempt from tax under section 501(a), or (B) trusts exempt from tax under section 165 of the Internal Revenue Code of 1939 or the corresponding provisions of prior revenue laws;

(2) purchased under contracts entered into under plans which (as of the time the contracts were entered into) were deemed to be plans described in section 403(a), or plans meeting the requirements of paragraphs (3), (4), (5), and (6) of section 165(a) of the Internal Revenue Code of 1939;

(3) provided for employees of the life insurance company under a plan which, for the taxable year, meets the requirements of paragraphs (3), (4), (5), (6), (7), (8), (11), (12), (13), (14), (15), (16), (19), and (20) of section 401(a);

(4) purchased to provide retirement annuities for its employees by an organization which (as of the time the contracts were purchased) was an organization described in section 501(c)(3) which was exempt from tax under section 501(a) or was an organization exempt from tax under section 101(6) of the Internal Revenue Code of 1939 or the corresponding provisions of prior revenue laws, or purchased to provide retirement annuities for employees described in section 403(b)(1)(A)(ii) by an employer which is a State, a political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing; or

(5) purchased under contracts entered into with trusts which (at the time the contracts were entered into) were individual retirement accounts described in section 408(a) or under contracts entered into with individual retirement annuities described in section 408(b).

(6) purchased by —

(A) a governmental plan (within the meaning of section 414(d)), or

(B) the Government of the United States, the government of any State or political subdivision

thereof, or by any agency or instrumentality of the foregoing, for use in satisfying an obligation of such government political subdivision, or agency or instrumentality to provide a benefit under a plan described in subparagraph (A).

(e) Interest Paid. – For purposes of this part, the interest paid for any taxable year is the sum of —

(1) Interest on indebtedness. – All interest for the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from taxation under this chapter.

(2) Amounts in the nature of interest. – All amounts in the nature of interest, whether or not guaranteed, for the taxable year on insurance or annuity contracts (including contracts supplementary thereto) which do not involve, at the time of accrual, life, health, or accident contingencies.

(3) Discount on prepaid premiums. – All amounts accrued for the taxable year for discounts in the nature of interest, whether or not guaranteed, on premiums or other consideration paid in advance on insurance or annuity contracts.

(4) Interest on certain special contingency reserves. – Interest for the taxable year on special contingency reserves under contracts of group term life insurance or group health and accident insurance which are established and maintained for the provision of insurance on retired lives, for premium stabilization, or for a combination thereof.

SEC. 818. ACCOUNTING PROVISIONS.

(a) Method of Accounting. – All computations entering into the determination of the taxes imposed by this part shall be made —

(1) under an accrual method of accounting, or

(2) to the extent permitted under regulations prescribed by the Secretary, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

* * *

§1.804-4 Investment yield of a life insurance company.

(a) *Investment yield defined.* – Section 804(c) defines the term "investment yield" of a life insurance company for purposes of part I, subchapter L, chapter 1 of the Code. Investment yield means gross investment income (as defined in section 804(b) and paragraph (a) of §1.804-3), less the deductions provided in section 804(c) and paragraph (b) of this section for investment expenses, real estate expenses, depreciation, depletion, and trade or business (other than an insurance business) expenses. However, such expenses are deductible only to the extent that they relate to investment income and the deduction of such expenses is not disallowed by any other provision of subtitle A of the Code. For example, investment expenses are not allowable unless they are ordinary and necessary expenses within the meaning of section 162, and under section 265, no deduction is allowable for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from taxation under chapter 1 of the Code. A deduction shall not be permitted with respect to the same item more than once.

(b) Deductions from gross investment income – (1) Investment expenses. (i) Section 804(c)(1) provides for the deduction of investment expenses by a life insurance company in determining investment yield. "Investment expenses" are those expenses of the taxable year which are fairly chargeable against gross investment income. For example, investment expenses include salaries and expenses paid exclusively for work in looking after investments, and amounts expended for printing, stationery, postage, and stenographic work incident to the collection of interest. An itemized schedule of such expenses shall be attached to the return.

(ii) Any assignment of general expenses to the investment department of a life insurance company for which a

deduction is claimed under section 804(c)(1) subjects the entire deduction for investment expenses to the limitation provided in that section and subdivision (iii) of this subparagraph. As used in section 804(c)(1), the term "general expenses" means any expense paid or incurred for the benefit of more than one department of the company rather than for the benefit of a particular department thereof. For example, if real estate taxes, depreciation, or other expenses attributable to office space owned by the company and utilized by it in connection with its investment function are assigned to investment expenses, such items shall be deductible as general expenses assigned to or included in investment expenses and as such shall be subject to the limitation of section 804(c)(1) and subdivision (iii) of this subparagraph. Similarly, if an expense, such as a salary, is attributable to more than one department, including the investment department, such expense may be properly allocated among these departments. If such expenses are allocated, the amount properly allocable to the investment department shall be deductible as general expenses assigned to or included in investment expenses and as such shall be subject to the limitation of section 804(c)(1) and subdivision (iii) of this subparagraph. If general expenses are in part assigned to or included in investment expenses, the maximum allowance (as determined under section 804(c)(1)) shall not be granted unless it is shown to the satisfaction of the district director that such allowance is justified by a reasonable assignment of actual expenses. The accounting procedure employed is not conclusive as to whether any assignment has in fact been made. Investment expenses do not include Federal income and excess profits taxes, if any. In cases where the investment expenses allowable as deductions under section 804(c)(1) exceed the limitation contained therein, see section 809(d)(9).

* * *

APPENDIX H

§12-7-330. Organizations that are exempt.

The following organizations shall be exempt from taxation under this chapter:

* * *

(2) Building and loan associations and cooperative banks without capital stock, organized and operated for mutual purposes and without profits, and insurance companies;

* * *

§12-19-150. Chapter provisions inapplicable to certain organizations, companies and associations.

The provisions of this chapter shall not apply to any nonprofit corporation organized under Article 1 of Chapter 31 of Title 33 for religious purposes, any volunteer fire departments and rescue squads, any cooperative organized under Chapter 45 or 47 of Title 33, any building and loan association or any credit union doing a strictly mutual business or to any insurance, fraternal, beneficial or mutual protection companies or associations or to any foreign corporation whose entire income is not included in gross income for federal income tax purposes due to any treaty obligation of the United States.

§38-5-310. Annual fixed license fees; collection and disposition.

The Chief Insurance Commissioner shall collect in addition to all other license fees or taxes provided by law, from all companies which shall be licensed by him to do business in this State, an annual fixed license fee determined as follows: One hundred dollars for each kind of insurance for which the company is licensed as defined in items (a) through (g) of §38-5-20, not to exceed three hundred dollars; *provided, however,* each mutual company doing a property business only in no more than three counties shall pay an annual fixed license fee of fifty dollars and each mutual company doing a property business only in a single county shall pay an annual fixed license fee of twenty dollars.

All of such insurance license fees collected by the Chief Insurance Commissioner shall be paid over to the State Treasurer at least once a month.

§38-5-410. Two percent graded license fee on domestic life insurance companies.

In addition to any and all other license fees or taxes there is hereby imposed upon each domestic life insurance company of any class licensed by the Commissioner and incorporated under the laws of this State, an additional and graded license fee in an amount equal to two percent of the total premiums, that is, total premium income or total premium receipts, from insurance contracts issued to residents of this State or paid from a point located within this State, less any dividends or bonuses paid in cash or applied in abatement of premiums or credited to policyholders of such company, as collected from citizens of or residents of this State during the year next preceding the date of the return. Such premiums shall not include considerations received from annuity contracts. The additional and graded license fee imposed in this section shall not exceed five percent the net income of the company as determined under the provisions of Chapter 7 of Title 12; *provided,* that in addition to the deductions allowed by such chapter there shall be allowed in computing net income any addition to policy reserves as may be required by the Commissioner, but no more than such required amount.

Supreme Court, U. S.
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No. 78-1825

In the Supreme Court of the United States

OCTOBER TERM, 1978

LIBERTY LIFE INSURANCE COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the district court (Pet. App. A 1a-13a) is reported at 439 F. Supp. 927. The opinion of the court of appeals (Pet. App. D 16a-30a) is reported at 594 F. 2d 21.

JURISDICTION

The judgments of the court of appeals (Pet. App. F 36a-37a) were entered on March 8, 1979. The petition for a writ of certiorari was filed on June 6, 1979. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether a portion of a state tax on domestic insurance companies, in an amount equal to two percent of premiums, but not to exceed five percent of net

income, may be allocated to investment expenses for federal income tax purposes under Section 804(c)(1) of the Internal Revenue Code of 1954.

2. Whether the difference between the amount of mortgage cancellation policy premiums that were paid on an annual basis and the total premiums that would have been payable on a monthly basis was deductible "discounts in the nature of interest" on advance premium payments within the meaning of Section 805(e)(3) of the Internal Revenue Code of 1954.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 804 and 805 of the Internal Revenue Code (26 U.S.C.), Treasury Regulations on Income Tax, Sections 1.804-4 and 1.805-8 (26 C.F.R.), and S.C. Code § 37-130.1 (1962), are set forth in the Appendix, *infra*, 1a-6a.

STATEMENT

1. *The state premium tax issue.* Petitioner is a stock life insurance company chartered under the laws of South Carolina, with its principal place of business in that state (Pet. App. A 2a). As a domestic life insurance company, petitioner was subject to an annual "graded license fee" in the amount of two percent of its total premium receipts from within South Carolina subject to a maximum limitation of five percent of net income for the year in question (Pet. App. A 5a-6a). See S.C. Code § 37-130.1 (1962), Appendix, *infra*, 5a-6a.

In 1965, petitioner would have been subject, but for the limitation provided for by the statute, to a license fee of $475,946.42, which was two percent of its premium receipts for that year. Under the maximum limitation,

however, its license fee for 1965 was limited to $222,911.93, which is five percent of its net income (Pet. App. A 6a).

Petitioner did not reflect any portion of the South Carolina license fee as an investment expense on its annual statement filed with the states in which it did business (R. 16, 192-193, 739).[1] On its 1965 federal income tax return, petitioner claimed a deduction of $47,159.42 of this license fee as an "investment expense" under Section 804(c)(1) of the Code, thereby reducing the "taxable investment income" component of its overall taxable income. This allocation was based on the ratio of petitioner's gross investment income to its total gross income (R. 14). On audit, the Commissioner of Internal Revenue disallowed the deduction, and required the fee to be treated entirely as an insurance expense deductible only in the computation of "gain from operations" under Section 809(d)(12) (R. 15). Petitioner paid the additional taxes determined to be due, and filed a claim and a supplemental claim for refund (Pet. App. A 2a).[2]

Upon denial of its claims for refund, petitioner instituted this action in the United States District Court for the District of South Carolina. The district court upheld the Commissioner's position (Pet. App. A 2a). It observed that the state license fee was based solely on the receipt of premiums from within the state, subject only to a maximum limitation based on overall net income. It

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[1] "R." refers to the record appendix filed in the court of appeals.

[2] In a supplemental claim, petitioner sought to allocate $173,344.75 of this license fee to investment expenses (Pet. App. A 6a). This amount represents five percent of the investment income component of the total net income taken into account in determining the maximum amount of the tax (R. 15).

therefore concluded that the fee was not incurred as a result of conducting investment activity within South Carolina and that no portion could be treated as an "investment expense" (Pet. App. A 11a-12a).

The court of appeals affirmed. It likewise ruled that the South Carolina statute taxes only premium income and that the "fortuity" that investment income is taken into account in determining the maximum limit does not alter the essential character of the state tax (Pet. App. D 18a-19a).

2. *The premium discount question.* During the years at issue, petitioner offered mortgage cancellation insurance designed to provide for the payment of a borrower's remaining indebtedness at the time of his death. This insurance was sold through savings and loan associations, which were the designated beneficiaries, and which also received commissions on premiums received. When this form of insurance was first offered by petitioner, premiums were paid by the borrowers to the associations and remitted by the associations to petitioner on a monthly basis (Pet. App. A 6a).

In 1964, petitioner agreed to accept annual payments from the associations at the beginning of the period of coverage in amounts less than the aggregate amount of monthly payments that would otherwise have been due from them over the course of the year. The associations, however, generally continued to collect premiums from the borrower on a monthly basis (Pet. App. A 6a-7a). In 1956, petitioner began to offer a choice on its policy forms between annual and monthly "modes" of payment, with the monthly premium calculated as a percentage of the annual rate (Pet. App. A 7a).

On its 1965 federal income tax return, petitioner deducted the difference between the total amount of mortgage cancellation premiums paid on an annual basis and the amount that would have been received had these premiums been paid on a monthly basis, as "discounts in the nature of interest * * * on premiums or other consideration paid in advance" under Section 805(e)(3) of the Code of 1954 (Pet. App. A 7a). Although the Commissioner did not question this treatment during the initial audit, the government challenged petitioner's entitlement to such a deduction in the district court by way of an offset against any refund that would otherwise be due (R. 7).

The district court upheld the government's position that petitioner was not entitled to a Section 805(e)(3) deduction. It ruled that this "discount" arrangement represented simply an annual mode of payment (rather than an advance payment of monthly premiums) and that the "discount" on such annual payments was not "in the nature of interest" (Pet. App. A 12a-13a). The court's holding was based on its findings that: (1) the method used in deriving a monthly rate from an annual rate was characteristic of ordinary conversions of premiums from one "mode" of payment to another; (2) a policyholder was entitled, on cancellation, to receive only a pro rata portion of the annual premium attributable to future months, (3) the annual premium did not reflect simply the "present value" of monthly premiums otherwise payable, (4) the "discount" on annual payments would, if converted into a rate of interest, substantially exceed the rate of interest paid by petitioner in the case of advance premium deposit arrangements, (5) petitioner enjoyed substantial expense savings where such premiums were paid on an annual basis, (6) petitioner also enjoyed competitive advantages in allowing mortgage cancellation

premiums to be paid, at a reduced rate, on an annual basis, and (7) petitioner failed to file informational returns reporting any "interest" payments based on these arrangements (Pet. App. A 7a-8a).

The court of appeals affirmed (Pet. App. D 23a-30a). In so holding, it relied on the district court's findings that petitioner did not calculate its annual mortgage cancellation insurance premium by computing the present value of future payments. Rather, the real interest factor in the discounts at issue was substantially higher than that used to calculate its advance premium deposit arrangements. As the court of appeals observed, "[w]e think that these facts demonstrate quite clearly that the discount claimed here bore little or no relation to the amount which [petitioner] expected to earn during the year 1965 on the annual premiums deposited by the associations, and therefore, the discount was not 'a discount in the nature of interest' " (Pet. App. D 27a).

ARGUMENT

1. *State premium tax issue.* Life insurance companies are taxed pursuant to a distinct statutory scheme. Sections 801-820 of the Internal Revenue Code of 1954 (as added by Section 2(a) of the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 73 Stat. 112-138) provide for a series of three computations or "phases" directed at determining the various components of a life insurance company's overall "life insurance company taxable income" under Section 802(b). In general, the net result of these computations is to impose a tax currently on the company's "taxable investment income" (that portion of net investment yield not deemed necessary for the fulfillment of policyholder obligations), plus half of its underwriting income (*i.e.*, half of the amount by which the company's overall "gain from operations," as determined under Section 809 of the Code exceeds taxable investment income as determined under

Sections 804 and 805). See *United States* v. *Atlas Insurance Co.*, 381 U.S. 233 (1965); *Commissioner* v. *Standard Life & Accident Insurance Co.*, 433 U.S. 148 (1977). Since the tax on the remaining half of the company's underwriting gains will generally be deferred until such sums are distributed to stockholders,[3] it is ordinarily to the company's advantage to shift as much of its income as possible to the underwriting computation and as many of its deductions as possible to the "taxable investment income" computation.

The decision below correctly held that the state premium taxes paid by petitioner were deductible only as underwriting or insurance expenses deductible under Section 809(d)(12) of the Code (since redesignated as Section 809(d)(11)), and not as "investment expenses" deductible under Section 804(c)(1). The question whether such an item can be allocated or apportioned between investment expense and underwriting expense is not new to the present statutory scheme enacted in the 1959 Act. It first arose as early as 1921 when the income tax on life insurance companies was limited to their free investment income (an amount roughly equivalent to the "taxable investment income" under the present statute). See Sections 242-247 of the Revenue Act of 1921, ch. 136, 42 Stat. 261-264. It was established from the outset that the "taxes imposed by the State on premiums" were nondeductible items because they belonged to the "nontaxable end of [the company's] business." *Hearings on H.R. 8245, Internal Revenue, Before the Senate Comm. on Finance*, 67th Cong., 1st Sess. 90 (1921)

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[3] The underwriting income not taxed in the first instance is added to a "policyholder's surplus account" pursuant to Section 815 of the Code. Subsequent distributions (or other reductions) of this account are included, at that time, in the company's taxable income under Section 802(b)(3).

(statement of Dr. T.S. Adams, Tax Adviser to the Treasury Department). See 8 J. Mertens, *Law of Federal Income Taxation* § 44.38, at 138 & 145-146 (Rev. 1978).

Such a tax on premiums is imposed by most states and is the "normal form of taxation [of life insurance companies] at the state level" (1 T. Nash, *Federal Taxation of Life Insurance Companies* § 4.07, at 4-15 (1977)). The only thing that would serve to distinguish the "graded license fee" imposed by South Carolina from other state premium taxes is the fact that it is subject to a maximum limitation based on a percentage of the company's overall net income. But as the court of appeals correctly pointed out, the adoption of such a limitation "does not convert the premium fee into a tax on investment income. The fortuity that the legislature chose a formula which included investment income to determine the maximum limit of the tax does not alter the character of the fee itself" (Pet. App. D 19a).

Accordingly, the courts below correctly rejected petitioner's contention that the tax in question is a tax on the privilege of doing *all* types of business—including investment business—within the state. Indeed, it is wholly irrelevant under the South Carolina statute where the company's income other than premiums is derived, or whether it does any other type of business at all within the state. Only the receipt of premiums from within the state is taxed, not the receipt of other types of income. The fact that a company enjoys the benefit of a limitation on the amount of that tax furnishes no basis for treating any portion of that limited tax liability as an expense "fairly chargeable against gross investment income." Treasury Regulations on Income Tax, Section 1.804-4(b)(1)(i), Appendix, *infra*, 3a.

2. *The premium discount question.* The decision below also correctly held that petitioner was not entitled to a deduction under Section 805(e)(3) for discounts in the nature of interest for the difference between the annual and monthly modes of payment of mortgage cancellation premiums. Section 805(e)(3) provides for an "interest paid" deduction in computing "taxable investment income" for "discounts in the nature of interest, whether or not guaranteed, on premiums or other consideration paid in advance on insurance or annuity contracts." But in order for such a premium adjustment to qualify for deductions, the company must establish that the reduced or "discounted" premiums in fact represent "premiums * * * paid in advance" and that the reduction or "discount" is actually "in the nature of interest." Here, petitioner's claimed deduction fails on both counts.

First, the reduced annual payment is not a premium paid in advance. Life insurance companies have long offered their policyholders the option of paying premiums on conventional policies either annually or in semi-annual, quarterly or monthly installments. See *Commissioner* v. *Standard Life & Accident Insurance Co.*, *supra*. When the policyholder elects to pay on an annual basis, however, he is not considered to have made an advance payment on future premiums, even though such a premium is paid at the outset of the annual period of coverage.[4]

Second, while the company imposes an additional charge when the policyholder elects to pay his premiums in installments, to compensate it for the loss of investment income it would otherwise earn,[5] the difference between

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[4]As the court of appeals noted (Pet. App. D 27a), Congress did not intend to treat such premiums as "premiums * * * paid in advance" within the scope of Section 805(e)(3).

[5]See, *e.g.*, J. Maclean, *Life Insurance* 107 (9th ed. 1962).

the premiums paid on an annual "mode" and the amount paid over the course of the year when paid on a semi-annual, quarterly or monthly mode, is not considered to be "interest" from either the company's or the policyholder's standpoint. As the district court observed (Pet. App. A 7a), the difference between the annual payment and the sum of the monthly payments on the mortgage cancellation policies is simply a function of the difference between "modes" of payment. The difference between the payment options extended here is analogous to the optional modes of premium payment generally available to the holders of conventional life insurance policies. Indeed, while the mortgage cancellation premiums were originally paid solely on a monthly basis, more recent mortgage cancellation policies issued by the petitioner expressly provided for the payment of premiums "annually, semi-annually, quarterly, or monthly, *according to the Mode of Premium Payments*" (emphasis added) (R. 845).

Finally, as the district court (Pet. App. A 7a-8a) and the court of appeals (Pet. App. D 28a) concluded, the characterization of the annual payments as simply another mode of payment (rather than as advance payment of 12 monthly premiums) is unaffected by petitioner's election to report its reserves on the "mid-terminal" basis rather than on the "mean" reserve method characteristically used in the case of conventional life insurance. The method of reporting reserves is irrelevant to the question presented here because petitioner was free to use either method of reporting. In sum, there is nothing in the terms of Section 805(e)(3) or in the legislative history that would suggest that an annual payment mode could be regarded as the payment of advance premiums

simply because the company does not assume an annual payment in computing its reserves.[6]

At all events, the decision below correctly concluded that the difference between the annual and monthly modes of payment was not "in the nature of interest" within the meaning of Section 805(e)(3). While the legislative history of Section 805(e)(3) is somewhat scant, the Senate Committee report accompanying the 1959 Act confirms the congressional understanding that all items included under Section 805(e) "are similar in nature to the deduction for interest paid or credited on deposits by a bank." S. Rep. No. 291, 86th Cong., 1st Sess. 16-17 (1959). See also H.R. Rep. No. 34, 86th Cong., 1st Sess. 10 (1959). In enacting the "discounts in the nature of interest" provision of Section 805(e)(3), Congress intended to eliminate a distinction that had been drawn under prior law between advance premium deposit arrangements and economically equivalent arrangements under which the company agreed to accept as full payment the present value of the future premiums. Interest paid deductions had been held allowable in the former case in which the company becomes the policyholder's debtor (see *Equitable Life Assurance Society* v. *Commissioner*, 44 B.T.A. 293, 309-310 (1941), modified and aff'd on other grounds, 137 F. 2d 623 (2d Cir. 1943), aff'd, 321 U.S. 560 (1944)) and disallowed in the latter case (see *Illinois Life*

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[6]In computing mean reserves, full annual payment is generally assumed, whether or not it has in fact been paid by the end of the calendar year. See *Commissioner* v. *Standard Life & Accident Insurance Co.*, *supra*, 433 U.S. at 150. Conversely, as petitioner points out (Pet. 7), the "mid-terminal" reserve does not reflect the receipt of premiums attributable to periods beyond the end of the calendar year, even though they may actually have been paid on an annual basis.

Insurance Co. v. *Commissioner*, 30 B.T.A. 1160, 1164-1165 (1934), aff'd on another issue, 80 F. 2d 280 (7th Cir. 1935), rev'd on such other issue, 299 U.S. 88 (1936); *Monarch Life Insurance Co.* v. *Commissioner*, 38 B.T.A. 716, 727 (1938), aff'd, 114 F. 2d 314 (1st Cir. 1940)).

Here, however, the annual payment mode was not economically equivalent to the advance premium deposit arrangements petitioner extended to its policyholders in other circumstances. The "discounts" in this case reflected effective interest rates ranging between 7 and 14 percent per annum, which exceeded the 3 1/2 and 4 percent per annum interest petitioner allowed under its advance premium deposit agreements.[7] Indeed, as the court of appeals noted, the discounts bore little or no relationship to the amounts petitioner could expect to have earned on its investments in the period in question (Pet. App. D 27a). In short, unlike the discount arrangements involved in *Monarch Life* and *Illinois Life*, the annual premium did not reflect simply the "present value of the future amount due" (*Commissioner* v. *Monarch Life Insurance Co.*, *supra*, 114 F. 2d at 326).

Moreover, petitioner's position that its rate adjustments were "discounts in the nature of interest" is contrary to the proviso of Treasury Regulations, on Income Tax, Section 1.805-8(b)(2) (Appendix, *infra*, 4a), that "[a]mounts in the nature of interest do not include amounts derived from or representing mortality gains, expense savings, underwriting profits, or other items not in the nature of interest." As the district court noted (Pet. App. A 8a), the reduction permitted to those

[7]The arrangement here was also unlike an advance premium deposit because no interest was credited on refunds and the policyholder received only a pro rata portion of the amount actually paid.

policyholders who remitted their premiums on an annual basis represented, in large measure, reduced commissions payable on annual payments and the reduced recordkeeping costs when premiums were paid annually. In sum, since the difference between the annual and monthly modes of payment did not represent compensation paid for the use of the policyholder's money, the decision below correctly held that it was not a discount "in the nature of interest."

Finally, although petitioner acknowledges (Pet. 18) that this case is the first appellate decision on both of the questions presented, it contends that there is a potential for conflict on the premium discount issue with *Liberty National Life Insurance Co.* v. *United States*, 39 A.F.T.R. 2d 77-540 (N.D. Ala. 1976), appeal pending, No. 77-1578 (5th Cir. argued April 15, 1979), and that the court should hold the petition to await the decision of the Fifth Circuit in that case (see Pet. 13). But since the filing of the petition, the Fifth Circuit has reversed the decision of the district court in that case. It has held that the difference between the weekly premiums and the annual and semi-annual premiums was not "discounts in the nature of interest" within the meaning of Section 805(e)(3). *Liberty National Life Insurance Co.* v. *United States*, No. 77-1578 (5th Cir. August 13, 1979). There is accordingly no conflict of decisions warranting review by this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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AUGUST 1979

DOJ-1979-08

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 804 [as added by Section 2(a) of the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 73 Stat. 115] TAXABLE INVESTMENT INCOME.

* * * * *

(c) *Investment Yield Defined.*—For purposes of this part, the term "investment yield" means the gross investment income less the following deductions—

(1) *Investment expenses.*—Investment expenses for the taxable year. If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed the sum of—

(A) one-fourth of one percent of the mean of the assets (as defined in section 805(b)(4)) held at the beginning and end of the taxable year,

(B) the amount of the mortgage service fees for the taxable year, plus

(C) whichever of the following is greater:

(i) one-fourth of the amount by which the investment yield (computed without any deduction for investment expenses allowed by this paragraph) exceeds 3 3/4 percent of the mean of the assets (as defined in

section 805(b)(4) held at the beginning and end of the taxable year reduced by the amount described in subparagraph (B), or

(ii) one-fourth of one percent of the mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees for the taxable year.

* * * * *

SEC. 805 [as added by Section 2(a) of the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 73 Stat. 118] POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS.

* * * * *

(e) *Interest Paid.*—For purposes of this part, the interest paid for any taxable year is the sum of—

(1) *Interest on indebtedness.*—All interest for the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from taxation under this chapter.

(2) *Amounts in the nature of interest.*—All amounts in the nature of interest, whether or not guranteed, for the taxable year on insurance or annuity contracts (including contracts supplementary thereto) which do not involve, at the time fo accrual, life, health, or accident contingencies.

(3) *Discount on prepaid premiums.*—All amounts accrued for the taxable year for discounts in the nature of interest, whether or not guaranteed, on premiums or other consideration paid in advance on insurance or annuity contracts.

* * * * *

Treasury Regulations of Income Tax (26 C.F.R.):

1.804-4 *Investment yield of a life insurance company.*

* * * * *

(b) *Deductions from gross investment income*—(1) *Investment expenses.* (i) Section 804(c)(1) provides for the deduction of investment expenses by a life insurance company in determining investment yield. "Investment expenses" are those expenses of the taxable year which are fairly chargeable against gross investment income. For example, investment expenses include salaries and expenses paid exclusively for work in looking after investments and amounts expended for printing, stationery, postage, and stenographic work incident to the collection of interest. An itemized schedule of such expenses shall be attached to the return.

* * * * *

1.805-8 *Interest paid.*

* * * * *

(b) *Interest paid defined.* For purposes of part I, subchapter L, chapter 1 of the Code,

the term "interest paid" as used in section 805(e) means the sum of—

* * * * *

(2) All amounts in the nature of interest, whether or not guaranteed, for the taxable year on insurance or annuity contracts (including contracts supplementary thereto) which do not involve, at the time of accrual, life, health, or accident contingencies. Amounts in the nature of interest do not include amounts derived from or representing mortality gains, expense savings, underwriting profits, or other items not in the nature of interest. Amounts in the nature of interest include so-called excess-interest dividends as well as guaranteed interest accrued within the taxable year on such contracts. A contract to pay insurance benefits in installments over a specified period, for example, a contract to pay the insurance benefit in 10 annual installments, is considered as a supplementary contract not involving life contingencies. It is immaterial whether the optional mode of settlement specified in the insurance or annuity contract arises from an option exercised by the insured during his or her lifetime or from an option exercised by either the insured or a beneficiary after the policy matured. Thus, no distinction is made based on the person

choosing the method of payment, and the full amount of the interest accrued, and not merely the guaranteed interest, is considered as interest paid. Amounts in the nature of interest include interest on dividends left on deposit with the company and interest on premiums paid in advance.

(3) All amounts accrued for the taxable year for discounts in the nature of interest, whether or not guaranteed, on premiums or other consideration paid in advance on insurance or annuity contracts. Such accrual shall be determined in accordance with the rules prescribed in section 818(b) and the regulations thereunder. For example, if at the beginning of the taxable year 1958 a life insurance company granted a discount in the nature of interest of $40 as the result of the prepayment of life insurance premiums for 5 years, the company may, under the straight line method, accrue $8 in 1958 and each of the four succeeding taxable years ($40 ÷ 5 = $8) and include this $8 as interest paid for each such taxable year.

* * * * *

S.C. Code §37-130.1 (1962):

Two per cent graded license fee on domestic life insurance companies. In addition to any and all other license fees or taxes there is hereby

imposed upon each domestic life insurance company of any class licensed by the Commissioner and incorporated under the laws of this State, an additional and graded license fee in an amount equal to two per cent of the total premiums, that is, total premium income or total premium receipts, from insurance contracts issued to residents of this State or paid from a point located within this State, less any dividends or bonuses paid in cash or applied in abatement of premiums or credited to policyholders of such company, as collected from citizens of or residents of this State during the year next preceding the date of the return. Such premiums shall not include considerations received from annuity contracts. The additional and graded license fee imposed in this section shall not exceed five per cent of the net income of the company as determined under the provisions of chapter 5 of Title 65; *provided*, that in addition to the deductions allowed by such chapter there shall be allowed in computing net income any addition to policy reserves as may be required by the Commissioner, but no more than such required amount.

Supreme Court, U.S.
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No. 78 - 1825

IN THE
Supreme Court of the United States

October Term, 1978

LIBERTY LIFE INSURANCE COMPANY,
PETITIONER

v.

UNITED STATES OF AMERICA,
RESPONDENT

On Petition For A Writ of Certiorari To The United States Court of Appeals For The Fourth Circuit

REPLY BY PETITIONER

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IN THE SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1978

No. 78-1825

LIBERTY LIFE INSURANCE COMPANY,
Petitioner
v.
UNITED STATES OF AMERICA,
Respondent

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY BY PETITIONER

Liberty Life Insurance Company submits this reply to the brief of the United States in opposition to its petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fourth Circuit in this case. In replying to respondent's arguments, petitioner relies on its petition which fully discusses its position with respect to the license fee and discount questions.

I. LICENSE FEE QUESTION

Respondent's entire case, as presented in its brief, rests on labeling the license fee as a premium tax. Once so labeled, respondent then contends (Res. Br., pp. 7-8) that it has always been established that state premium taxes are not deductible as investment expenses. As pointed out previously by petitioner (Pet., p. 12), South Carolina law does not call the tax a premium tax, petitioner does not record it on its Annual Statement as a premium tax, and the tax does not function in petitioner's case as a premium tax. South Carolina law designates the tax a license fee and it functions in petitioner's case as

an income tax. There are no provisions in the Internal Revenue Code or the Regulations which prevent an allocation of license fees or state income taxes as investment expenses where, as in petitioner's case, there is a basis for allocation such as an increase attributable directly to investment income. Accordingly, regardless of the name given to this tax, a portion of it is deductible as an investment expense since it results directly from the earning of investment income.

While the license fee does not function as a premium tax, respondent has not shown that there is any case law, statute, ruling, or regulation which would prevent an allocation of a premium tax as an investment expense where there is a basis for allocation such as an increase attributable directly to investment income. Respondent's sole justification for its position is a comment made over fifty years ago by a Treasury Department witness, Dr. T. S. Adams, in connection with deliberations on the 1921 Act, which has long since been repealed.

It should be noted that respondent did not quarrel with petitioner's comparison of the license fee to the profit-sharing allocation issue in *Liberty National Life Insurance Company v. United States*, 39 AFTR 2d 77-540 (D.C. Ala.), rev'd, No. 77-1578 (5 Cir. August 13, 1979; petition for rehearing pending). Although the Fifth Circuit did not reach the profit-sharing issue in its decision, the holding of the Fourth Circuit on the license fee is contrary in theory to the holding of the District Court in *Liberty National* on the profit-sharing issue (See Pet., pp. 8-9).

For the reasons stated above and in the petition, the decision on the license fee presents an important question of federal tax law which should be decided by the Supreme Court of the United States. Significantly, respondent does not disagree that the license fee is an important question of federal tax law. Accordingly, the petition for a writ of certiorari on the license fee question should be granted.

II. DISCOUNT QUESTION

Since filing the petition for a writ of certiorari in this case, the Fifth Circuit Court of Appeals has reversed the decision in the *Liberty National* case with respect to the discount issue.

Liberty National Life Insurance Company v. United States, 39 AFTR 2d 77-540 (D.C. Ala.), rev'd, No. 77-1578 (5 Cir. August 13, 1979; petition for rehearing pending). Although both the Fourth and Fifth Circuits have ruled against the insurance company on the discount question, there nevertheless exists an important conflict between the Circuits on one of the major points in the case, namely, whether or not the discount can be partitioned between interest and expense.

Near the end of its decision in the *Liberty National* case, the Fifth Circuit stated as follows:

> We recognize that some part of the discount may be attributable to interest. In fact, the government admitted this at trial. Thus, it could be argued that the portion of the discount that is in the nature of interest is properly deductible. *Contra, Liberty Life Ins. Co. v. United States*, 594 F. 2d 21, 28 (4 Cir. 1979), *petition for cert. filed*, 47 U.S.L.W. 3814 (U.S. June 19, 1979) (No. 78-1825). This was not Liberty National's argument, however. At all stages of this proceeding it has argued that the discount was entirely and solely interest. Taxpayer refused to argue that the discount could be partitioned even after the possibility was discussed at oral argument before this panel.

It can be seen that the Fourth and Fifth Circuits disagree on whether a portion of the discount is in the nature of interest. The Fifth Circuit apparently felt that a portion was in the nature of interest, but the insurance company did not argue this point. In contrast, petitioner in this case did take the position in its appellate brief and at oral argument that the discount could be partitioned, but the Fourth Circuit did not agree. Interestingly enough, in both cases the government admitted that the discount included interest and the Courts held that a portion of the discount was interest. It would seem, therefore, that the proper and just decision in both cases is to allow a portion of the discount as interest paid.

There is also a conflict between the Circuits on whether

the ultimate issue is a question of law or a question of fact. The Fifth Circuit held that it was a question of law, but the Fourth Circuit viewed the discount as one of fact and held that petitioner had to show that the findings of the District Court were clearly erroneous. It would seem that since the discount includes interest, as a matter of law the portion of the discount which is allocable to interest should be allowed under Phase One. This argument by petitioner was ignored by the Fourth Circuit.

Respondent did not disagree with petitioner's position that its accounting treatment of the discount was entitled to great weight in light of the Supreme Court's decision in *Standard Life and Accident Insurance Company v. Commissioner*, 433 U.S. 148 (1977), and Section 818(a) of the Internal Revenue Code of 1954.

Accordingly, because of the conflict between the Circuits on whether or not the discount can be partitioned, and because of the importance of this question of federal tax law, it is respectfully submitted that the petition for a writ of certiorari on the discount question should be granted in order that this conflict may be resolved by the Supreme Court of the United States.

CONCLUSION

The petition for a writ of certiorari should be granted on both the license fee and discount questions.

Respectfully submitted,

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September, 1979